THE INVESTMENT COMPANY ACT AMENDMENTS OF 1995

HEARING

BEFORE THE

SUBCOMMITTEE ON
TELECOMMUNICATIONS AND FINANCE

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

H.R. 1495

OCTOBER 31, 1995

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THE INVESTMENT COMPANY ACT AMENDMENTS OF 1995

TUESDAY, OCTOBER 31, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2123, Rayburn House Office Building, Hon. Jack Fields [chairman] presiding.

Members present: Representatives Fields, Stearns, Gillmor, Deal, Frisa, White, Coburn, Markey, Collins, Furse and Klink.

Staff present: Linda Dallas Rich, majority counsel and Timothy Forde, minority counsel.

Mr. FIELDS. Today we are here to consider legislation affecting one of the most dynamic and successful industries in America, mutual funds. Mutual funds have brought Wall Street to Main Street. It used to be that only the very rich could afford the luxury of professional money management. Today, through mutual funds, even the humblest of investors has access to the best money managers around and those investors which, by the way, include myself, have welcomed the opportunity to participate.

Today, one out of every three households in the country own shares in a mutual fund. The mutual fund industry has brought benefits not only to investors but also to the entire economy. The high level of investment activity that mutual funds generate has helped provide small to medium-size businesses with access to capital markets. This in turn boosts employment.

Clearly, the mutual fund industry is among this country's most vital assets, which is why I introduced the legislation that we are here to consider. The Investment Company Act Amendments of 1995 will be the first significant amendment of investment company regulation in a quarter of a century. It addresses not only the mutual fund industry but every industry that is affected by the Investment Company Act of 1940. That includes all types of investment companies as well as companies that are not and should not be treated as investment companies.

Just about every law this subcommittee has reviewed in this Congress is a product of the 1930's. The Investment Company Act, which is the youngest of the bunch, at only 55 years old, is riddled with regulatory burdens that should be eliminated. Many of the act's provisions, such as the requirement mandating shareholder approval of a fund's investment advisory contracts even before the fund is offered to the public, have become meaningless burdens

that do nothing but drain resources. Other provisions, such as the restriction that limits mutual funds' investments in other funds inhibit the development of new products that would improve the array of investment choices available to mutual fund investors.

Every dollar spent by an investment company complying with regulatory overkill is a dollar out of the pockets of investors; and every new idea that is stifled by old regulations is a lost opportunity for not just mutual fund investors but every participant in our capital markets.

The legislation we will address today will improve the effectiveness of independent trustees by mandating that the majority of every investment company's board of trustees be independent. The legislation would improve shareholder communication by making advertising rules that apply to investment companies more flexible. Current law effectively prohibits useful advertising by limiting funds to advertising only information that is in their prospectuses. This results in a prospectus jammed with every conceivable piece of information the fund might want to advertise or a prospectus that is updated frequently at great expense to add that information, or it simply causes the fund to limit the information it is advertising. The Investment Company Act amendments will enable funds to advertise useful information to current and potential investors while maintaining important antifraud safeguards.

Mutual fund investors are beset by a confusing array of fees. Investment advisory fees, service fees, distribution fees, all these fees can make it very difficult for investors to compare one fund against another. This legislation will help pave the way for a new kind of mutual fund, a unified fee investment company. A UFIC will charge only one all-inclusive fee. With only one fee to compare, investors will be equipped with all the information they need to decide which fund offers the best value.

Now, I look forward to hearing the testimony of today's panelists regarding UFICs and the advantages they offer investors. As I said when I introduced this legislation, it is really a work in progress. The testimony of the distinguished witnesses we have here today will help us refine and improve the proposal that we started with.

I look forward to hearing from each of them and to continue our important work and to make sure that the laws that govern this remarkable industry help bring greater financial opportunity to all investors.

And that is the statement of the Chair. The Chair will now recognize the gentlelady from Illinois if she has an opening statement.

Ms. COLLINS. Mr. Chairman, I would like to ask unanimous consent that my opening statement be made a part of the record.

Mr. FIELDS. Without objection, so ordered.

[The prepared statement of Hon. Cardiss Collins follows:]

PREPARED STATEMENT OF HON. CARDISS COLLINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Chairman, as are millions of middle-class Americans, I too am a mutual fund investor, and therefore appreciate your calling this hearing to help inform and educate the public about the current market environment in which these funds are operating and to explore ways in which this body can promote more efficient management of these funds while still protecting fund consumers.

There is undoubtedly a need to reexamine mutual fund regulation to fully account for the constantly evolving size, complexity, and investment opportunities of our na-

tion's financial markets. While mutual funds have grown by more than 20 percent annually throughout the 1980's and into the 90's, Congress has not addressed the issue of fund regulation since 1970. The legislation that is the subject of today's hearing, H.R. 1495, the Investment Company Act Amendments of 1995, is a good starting point for addressing just this matter.

H.R. 1495 will amend the Investment Company Act of 1940, originally enacted to protect investors from fraud and abuse by investment companies, to revamp those provisions of the law that simply no longer make much sense given the shifting and unique demands of today's markets. Many of the recommended changes that would be made under this bill stem from the Securities and Exchange Commission's own 1992 review of the Investment Company Act entitled, "Protecting Investors: A Half Century of Investment Company Regulation."

For instance, in the area of SEC recordkeeping, inspection, and enforcement authority, H.R. 1495 would expand and clarify SEC oversight of the mutual fund industry, allowing the agency to better ensure compliance with the law and the protection of fund consumers. This is an important and needed focus, and one which I think helps improve the functioning of the mutual fund industry for all parties—regulators, fund companies, and investors alike.

Mr. Chairman, I look forward to working further with you and the Ranking Minority Member, Mr. Markey, to ensure the soundness of the mutual fund industry into the 21st Century and to guarantee that American mutual fund consumers are fully informed about their investments and protected against those who would perpetrate fraud and abuse on the system.

Mr. FIELDS. The gentleman from Oklahoma.

Mr. COBURN. Mr. Chairman, I also would request unanimous consent that my statement be made a part of the record.

Mr. FIELDS. Without objection, so ordered.

[The prepared statement of Hon. Tom A. Coburn follows:]

PREPARED STATEMENT OF HON. TOM A. COBURN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

The growth of mutual fund industry over the last 20 years has had a profound effect on the Nation's economy. Today's mutual fund industry manages $2.6 trillion for investors and has become an increasingly larger source of capital for American companies. In addition, the growth of the mutual fund industry has benefited investors both large and small. Nevertheless, this dynamic market is governed by a 50 year old act adopted in the New Deal era. The economy has changed dramatically since that era and it is important to review modernization of the regulations that govern the mutual fund industry.

Given the importance of the mutual fund industry to the economy I want to commend the Chairman for introducing this important piece of legislation and holding the hearings to open discussion on modernization in the regulation of mutual funds.

It is critical for the continued growth mutual fund industry that provide capital for the expansion of American businesses now competing in a global market that the management of mutual funds become more efficient, and operating expenses be lowered, by eliminating existing requirements that are costly to comply with and do not increase investor protection. It is in the investors interest that regulations be removed that are currently prohibiting the development of innovative new products and services.

I support the concepts of the proposed legislation that will reduce costs and, therefore, increase assets owned by the shareholders and remove regulations that do not increase investor protection. For this reason, I support the bill's provisions that broaden the type of information that can be included in mutual fund advertisements, so long as the advertisements are subject to prospectus liability; and the creation of a "unified fee investment company" or "UFIC" that will have a single, fixed fee, set by the vehicle's investment manager.

I want to thank each of the witnesses for coming today and look forward to their testimony. I am supportive of efforts by the Committee to achieve a National policy that will benefit the capital formation process and permit qualified U.S. investors greater investment opportunities while maintaining protections that will continue to promote investor confidence in our mutual fund industry.

Mr. FIELDS. The gentleman from New York, if he has an opening statement.

Mr. FRISA. Mr. Chairman, just very briefly, I just want to commend you for conducting this proceeding today. I think it is an exciting opportunity to bring the Investment Company Act into the twentieth century, the latter part, so that we can improve it and ensure the best formation of capital investment and I look forward to today's proceeding.

Mr. FIELDS. The Chair thanks the gentleman.

The gentlelady from Oregon.

Ms. FURSE. Thank you, Mr. Chairman.

No, I have no opening statement. I don't even want one entered into the record.

Thank you very much.

Mr. FIELDS. The Chair thanks the gentlelady.

The Chair will now recognize Mr. Barry Barbash, director of the Division of Investment Management of the United States Securities and Exchange Commission.

Mr. Barbash.

STATEMENT OF BARRY P. BARBASH, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. BARBASH. Thank you, Mr. Chairman. I don't know that I can match the brevity of the members of the subcommittee.

Mr. FIELDS. We hope you don't.

Mr. BARBASH. Thank you and the members of the subcommittee.

I appreciate the opportunity to testify before you this morning on behalf of the Securities and Exchange Commission regarding H.R. 1495, the Investment Company Act Amendments of 1995. The review of the Investment Company Act reflected in this legislation comes at an especially appropriate time.

A quarter of a century has passed since the Act was last significantly revised by the Congress. During this period, the investment company industry has grown dramatically. This growth has been, in no small part, due to the comprehensive framework for investment company regulation provided by the Federal securities laws, principally the Investment Company Act. The statutory framework has not only protected investors but it has also been sufficiently flexible to allow a creative industry to grow and flourish.

Underlying the legislation is a desire for more effective and less burdensome regulation. The Commission's initiatives, particularly over the past year, have sought to achieve the same goal. We have undertaken a number of measures designed to eliminate unnecessarily long disclosure and to encourage funds to make their disclosure documents more comprehensible to investors.

Most notable is our effort to facilitate the fund industry's development of profile prospectuses. The key element of these prospectuses is a short summary or profile of three to four pages in length that accompanies a fund's prospectus and outlines the fund's key features. Prototype profiles are now being used by six fund groups. A number of these fund groups, the Investment Company Institute, the Commission and state regulators all anticipate conducting investor research to assess the effectiveness of the profile prospectuses as disclosure documents.

Upon completion of this testing, the Commission will focus on such issues as whether the profile concept should be incorporated into Commission rules and whether profiles should be used as stand-alone disclosure documents.

The Commission appreciates the strong support that this initiative has received from Chairman Fields and other members of the subcommittee.

Many of our recent initiatives are designed to relieve burdens placed on directors of funds. Over the past 2 years, the Commission has amended various rules to eliminate provisions that made independent directors responsible for detailed reviews that involved more ritual than substance. Most recently, the Commission proposed amendments to its rule governing custody of fund assets outside the United States. As Chairman Levitt noted when the Commission proposed the amendments, fund directors have cited the foreign custody rule as the one they dislike the most and understand the least. The amendments would simplify the rule's requirements as well as provide funds with greater flexibility to select foreign custodians without sacrificing investor protection.

The Commission appreciates the subcommittee's efforts reflected in the legislation to improve and help bring into the twenty-first century many aspects of investment company operation and regulation. The legislation would complement the Commission's emphasis on better communications to investors by allowing the Commission to make its advertising rules more flexible and by giving the Commission rulemaking authority to address deceptive and misleading names.

The legislation would promote industry innovation by, among other things, facilitating the development of new investment products such as a new type of mutual fund that has a single fee covering all fund services and most expenses. The legislation would reduce regulatory burdens without sacrificing investor protections by simplifying the existing exemption under the Investment Company Act for private investment companies with no more than 100 investors and creating a new exemption for investment pools whose only shareholders are highly sophisticated investors.

The legislation would strengthen the framework of investment company regulation in other respects. It would reinforce the importance of the role of fund independent directors and would update shareholder voting requirements. It would also facilitate the Commission's efforts to increase the efficiency and effectiveness of its fund inspections program as well as help the Commission obtain important information about funds in times of market stress.

The Commission understands that the legislation remains a work in progress and that the subcommittee is actively working on other improvements to the Investment Company Act. The Commission appreciates the opportunity to participate in this process and looks forward to continuing to work with the subcommittee on the legislation.

Thank you, and I would be pleased to answer any questions you may have.

[The prepared statement of Barry P. Barbash follows:]

Prepared Statement of Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission

Chairman Fields and Members of the Subcommittee: I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission (the "Commission" or "SEC") on the proposed amendments designed to improve and modernize the Investment Company Act of 1940 (the "Investment Company Act" or the "Act").

I. INTRODUCTION

The review of the Investment Company Act reflected in the Investment Company Act Amendments of the 1995 comes at an especially appropriate time. A quarter of a century has passed since the Act was last significantly revised by the Congress.[1] The changes in the investment company (or "fund") industry since that time have been dramatic. In 1970, investors could choose from among 361 open-end management investment companies ("mutual funds").[2] Today, over 5,500 mutual funds (almost twice the number of stocks trading on the New York and American Stock Exchanges)[3] and over 500 closed-end management investment companies ("closed-end funds") are available to investors.[4] Funds, which in 1970 held approximately $48 billion in assets,[5] now hold over $3 trillion in assets.[6] That nearly one third of all U.S. households own investment company shares attests to the enormous significance of the fund industry to our country's economy and its citizens. Americans have entrusted their retirement monies, savings for their children's education, and even their ready cash to investment companies.

The Investment Company Act Amendments of 1995 would improve, and help bring into the 21st century, many aspects of investment company operation and regulation.[7] The legislation would complement the Commission's emphasis on better communications to investors by allowing the Commission to make its advertising rules more flexible and by giving the Commission rulemaking authority to address deceptive and misleading fund names. The legislation would reinforce the importance of the role of independent directors, as well as address shareholder voting requirements and related corporate governance procedures. The legislation would facilitate the development of new types of investment products by lifting restrictions on a mutual fund's investments in other funds and by giving fund sponsors the option of offering a new type of mutual fund that has a single fee covering all fund services and most expenses. The legislation also would facilitate the Commission's efforts to increase the efficiency and effectiveness of its investment company inspections program, as well as help the Commission obtain important information about funds in times of market stress. Finally, the legislation would simplify the existing exception from Investment Company Act regulation for "private" investment companies with no more than 100 investors and create a new exception for investment pools whose only shareholders are highly sophisticated investors.

The Commission welcomes this opportunity to fine-tune and enhance the Act, which has been characterized by the fund industry's leading trade association as "a model of effective legislation."[8] The Commission recognizes, as Chairman Fields said when the legislation was introduced, that the bill represents a "work in progress."[9] The Commission looks forward to working with the Subcommittee and its staff in this effort to improve and modernize investment company regulation.

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[1] Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970). *See also* Small Business Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980) (amending the Investment Company Act to create business development companies).

[2] INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK (1990) (hereinafter ICI 1990 FACT BOOK).

[3] Figures compiled by the Commission staff.

[4] Figures compiled by the Commission staff.

[5] ICI 1990 Fact Book, *supra* note 2.

[6] Figures compiled by the Commission staff.

[7] Some of the amendments were recommended by the Commission's Division of Investment Management in its 1992 report on investment company regulation. Division of Investment Management, SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (1992) (hereinafter PROTECTING INVESTORS REPORT).

[8] *Oversight Hearings on the Mutual Fund Industry: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103rd Cong., 1st Sess. 94 (1993) [hereinafter *1993 Oversight Hearings*] (prepared statement of Matthew P. Fink, President, Investment Company Institute).

[9] 141 CONG. REC. E868 (daily ed. Apr. 7, 1995).

II. RECENT COMMISSION INITIATIVES

The goal of the Investment Company Act Amendments of 1995—to improve and modernize the Investment Company Act—is one that the Commission itself has been seeking to achieve over the past several years. During this year, for instance, the Commission has undertaken many initiatives—particularly in the disclosure area—with this purpose in mind. Among the Commission's most recent significant initiatives are the following:

- *Profile Prospectuses.* The Commission has worked, and will continue to work, closely with the fund industry to promote investor protection by identifying ways to improve fund disclosure documents and eliminate unnecessary requirements. This summer, with the encouragement and strong support of Chairman Levitt, the Commission's Division of Investment Management (the "Division") cooperated with state regulators in facilitating the fund industry's development of "profile prospectuses." The key element of these prospectuses is a short summary or "profile" of 3 to 4 pages in length that accompanies a fund's prospectus and outlines the fund's key features. This approach, premised on the view that many investors will find that "less is often more" in mutual fund disclosure documents, is designed to encourage greater understanding and less confusion among mutual fund investors. Prototype profiles are now being used by six fund groups. A number of these fund groups, the Investment Company Institute, the Commission and state regulators all anticipate conducting investor research to assess the effectiveness of the profile prospectuses as disclosure documents. Upon completion of this testing, the Commission will focus on issues such as whether the profile concept should be incorporated into Commission rules and whether profiles should be used as stand-alone disclosure documents. The Commission appreciates Chairman Fields's recent praise of the profile concept and his support of this initiative.[10]
- *Summary Document for Employee Benefit Plans.* A number of observers have suggested that a short-form disclosure document resembling the profile would be particularly useful to participants in and beneficiaries of employee benefit plans. This past year, the Division, in a letter to the country's largest mutual fund group, facilitated the development of just such a document.[11]
- *Short-Form Money Market Fund Prospectus.* In another recent initiative designed to provide investors with more understandable disclosure documents, the Commission proposed a short-form prospectus for money market funds.[12] The proposal would tailor existing prospectus disclosure requirements to the unique characteristics of money market funds and the needs of money market fund investors. The proposal would promote the use of money market fund prospectuses that are simpler, shorter, and more informative. The Division anticipates that this will be the first proposal in a series of rulemakings designed to improve fund disclosure.
- *Commission Review of Fund Disclosure Documents.* The Commission's efforts to improve disclosure have extended beyond a review of applicable disclosure requirements to a reassessment of the process by which the staff reviews disclosure documents. We recognize that funds may be in a better position to improve the quality and readability of their prospectuses if the Commission improves this process. Last year, the Commission amended the rules governing the review of fund prospectuses to make the process more efficient for the funds as well as the Commission staff.[13] This year, the Division, in addition to reevaluating a number of its existing disclosure interpretations, appointed a disclosure ombudsman to the fund industry who has been working closely with funds to resolve disclosure issues and improve the quality of prospectuses.
- *Electronic Communications.* In recognition of the growing use of the information superhighway by investors, the Commission recently issued interpretive guidance and proposed rules designed to assist funds and other issuers in using electronic media to provide investors with information required under the federal securities laws. The Commission hopes that this action will encourage the use of these media.[14]

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[10] *See* Letter from Jack Fields, Chairman, House Subcomm. on Telecommunications and Finance, to Arthur Levitt, Chairman, SEC (July 31, 1995).

[11] Kirkpatrick & Lockhart (*pub. avail.* Apr. 5, 1995) (on behalf of Fidelity Institutional Retirement Services Co., Inc.).

[12] Money Market Fund Prospectuses, Securities Act Release No. 7196 (July 19, 1995), 60 FR 38454.

[13] Post-Effective Amendments to Investment Company Registration Statements, Securities Act Release No. 7083 (Aug. 17, 1994), 59 FR 43460.

[14] Use of Electronic Media for Delivery Purposes, Securities Act Release Nos. 7233 and 7244 (Oct. 16, 1995), 60 FR 53458, 53468.

• *Operational Initiatives.* The Commission's efforts to update its regulation of investment companies have included not only disclosure initiatives, but also measures intended to reduce operational burdens on investment companies. Early this year, the Commission adopted rules to allow a single mutual fund to offer multiple classes of shares with different sales charge arrangements and to permit mutual funds to impose certain types of deferred sales loads.[15] These rules give funds greater flexibility to tailor their sales load arrangements without having to apply to the Commission for exemptive relief.

In August of this year, the Commission proposed amendments to the Investment Company Act rule governing the custody of fund assets outside the United States.[16] The amendments, if adopted, would reduce the burdens currently placed on fund directors in reviewing foreign custody arrangements and provide funds with significantly more flexibility to select foreign custodians without sacrificing investor protection.

The Commission is committed to leaving no regulatory stone unturned in seeking to improve its oversight of the fund business. Thus, the Commission staff is working with the fund industry to review other rules that should be modernized or that impose unnecessary burdens, and the Commission expects that additional revisions to its rules will be forthcoming in the coming year.

During the coming year and beyond, the Commission intends to continue to improve investment company regulation and remove unnecessary regulatory burdens. Our efforts themselves can be enhanced and improved by Congress's retooling certain provisions of the Investment Company Act.

III. THE INVESTMENT COMPANY ACT AMENDMENTS OF 1995

The Investment Company Act Amendments of 1995 represent the most significant and comprehensive attempt at improving the Act undertaken in the past twenty-five years. The changes that would be effected by the proposed legislation are described in detail below.

Corporate Governance Provisions. The successful and safe operation of the fund industry over the last several decades is due in large part to the system of "checks and balances" prescribed by the Investment Company Act. The heart of the Act is a series of prohibitions on dealings between funds and their sponsors designed to ensure that the conflicts of interest and other abusive conduct that characterized the U.S. fund industry in the 1920s and 1930s are not repeated. To supplement these prohibitions, the Act requires that fund boards include members who are independent of the fund's sponsor and that fund boards monitor and address certain conflicts between the interests of fund insiders and shareholders. The Act also provides shareholders with a voice concerning fundamental changes in a fund's management or operations.

For some time, commentators have debated the effectiveness of the Act's corporate governance provisions.[17] Some have suggested that fund directors do not provide any real check on fund management and that shareholder voting is perfunctory and imposes unnecessary costs on funds. Others argue that the inherent conflicts between fund sponsors and shareholders make it uniquely appropriate for fund directors to have an active role in governance, and that directors generally have performed their responsibilities well. These commentators also assert that shareholder votes provide a valuable communicative and deterrent function. The Commission believes that the core concepts of the governance model embodied in the Act are sound and appear to have worked well.[18] The Commission believes, however, that certain of the Act's governance provisions could be improved.

The legislation would strengthen the independence of fund boards of directors and update the Act's shareholder voting requirements and related procedures. The Commission supports these amendments, although we have concerns about the potential

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[15] Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares, Securities Act Release No. 7143 (Feb. 23, 1995), 60 FR 11876; Exemption for Certain Open-End Management Investment Companies to Impose Contingent Deferred Sales Loads, Investment Company Act Release No. 20916 (Feb. 23, 1995), 60 FR 11887.

[16] Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 21259 (July 27, 1995), 60 FR 39592.

[17] *See* PROTECTING INVESTORS REPORT, *supra* note 7, at 251-82. *See also* notes 61 and 62 and accompanying text (discussing alternatives to the current corporate governance model embodied in the Act in connection with the proposed unified fee investment company).

[18] Representatives of the fund industry appear to agree as to the importance of fund boards [illegible]tchdogs for shareholders' interests and as a check on fund sponsors. *See 1993 Oversight* [illegible], *supra* note 8, 83 (prepared statement of Matthew P. Fink, President, Investment Com[illegible]itute).

effects of an amendment that would change the vote of fund shareholders required to approve certain actions taken by a fund.

Board of Directors. The Commission, particularly over the past two years, has stressed the importance of fund boards in the success of the fund industry. Chairman Levitt has said that a fund's independent directors are "the frontlines of investor protection."[19] Commissioner Wallman noted recently that they "play an essential role in a remarkable industry."[20] Recognizing the importance of fund boards, the legislation would enhance board independence by raising the required minimum percentage of independent directors on a board from forty percent to a majority.[21] We understand that this reflects the composition of many fund boards today. The legislation would therefore codify what would appear to be the norm in fund governance. The legislation also would give independent directors the sole responsibility for selecting and nominating other independent directors.[22]

The legislation would further strengthen the independent directors' ability to protect shareholder interests by giving independent directors the express authority to terminate investment advisory contracts.[23] At present, independent directors, along with the full board, are responsible for evaluating and approving the initial advisory contract and any subsequent renewals. While the full board and the fund's shareholders can terminate an advisory agreement at any time, the independent directors currently do not have this authority under the Act. The legislation would close this gap in fund governance.

Shareholder Voting. Reflected in the Act is the view that fund shareholders should have a voice on matters that fundamentally affect fund operations or the nature of their investment. A fund's investment objective is a key indicator of the potential risks and rewards inherent in investing in the fund. The objective often forms the basis for the decision to invest and remain invested in a fund. The legislation would recognize the significance of a fund's investment objective by requiring changes in the objective to be approved by the fund's shareholders.[24]

The legislation also would update the Investment Company Act's shareholder voting provisions by eliminating two requirements that appear to provide only minimal investor protection. Under existing law, a fund's initial agreement with its investment adviser must be voted upon by the fund's shareholders. This shareholder approval is virtually automatic since persons who supply the fund with its initial capital typically become shareholders of the fund and approve the advisory agreement prior to the fund's commencing a public offering of its shares. Moreover, investors participating in the fund's initial public offering, in effect, vote with their dollars to accept the fund's initial advisory arrangement. The legislation recognizes this view and would eliminate the perfunctory initial investment advisory agreement approval requirement.[25]

Another provision affording minimal investor protection that would be removed by the legislation is the Act's requirement that shareholders ratify the independent di-

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[19] *See* Arthur Levitt, Chairman, SEC, Remarks at the Second Annual Symposium for Mutual Fund Trustees and Directors, Washington, D.C. (Apr. 11, 1995); Arthur Levitt, Chairman, SEC, Remarks at the Mutual Funds and Investment Management Conference, Scottsdale, AZ (Mar. 21, 1994). "Independent directors" are directors who are not "interested persons" of an investment company under section 2(a)(19) of the Act. 15 U.S.C. § 80a-2(a)(19).

[20] *See* Steven M.H. Wallman, Commissioner, SEC, Remarks before the Investment Company Institute's 1995 Investment Company Directors Conference and New Directors Workshop, Washington, D.C. (Sept. 22, 1995).

[21] Section 2(a) of H.R. 1495 (amending section 10(a) of the Investment Company Act, 15 U.S.C. § 80a-10(a)).

[22] Section 2(a) of H.R. 1495 (amending section 10(a) of the Investment Company Act). *See also* section 16(a) of the Act, 15 U.S.C. § 80a-16(a) (regarding shareholder approval of fund directors).

[23] Section 2(b) of H.R. 1495 (amending section 15(a) of the Investment Company Act, 15 U.S.C. § 80a-15(a)). A similar approach is taken by certain Commission rules that require certain determinations be made by independent directors. *See, e.g.*, rule 12b-1 under the Investment Company Act, 17 CFR § 270.12b-1 (requiring that payment of asset-based sales charges by mutual funds only be made in accordance with a plan approved by a majority of the fund's independent directors).

[24] Sections 2(d) and 2(e) of H.R. 1495 (amending section 8(b)(1) of the Investment Company Act, 15 U.S.C. § 80a-8(b)(1), to require funds to adopt their investment objectives as a fundamental policy, and section 13(a)(1), 15 U.S.C. § 80a-13(a)(1), to require shareholder approval to change the objective).

[25] Section 2(b) of H.R. 1495 (amending section 15(a) of the Investment Company Act, 15 U.S.C. § 80a-15(a)). As drafted, the provision appears to eliminate the requirement for shareholders to approve advisory agreements in all cases, even when the agreement has been entered into after the commencement of a fund's public offering. *See* W. John McGuire, *Legislation Signals Congressional Intent to Review Investment Company Regulation,* 2 INVESTMENT LAW. 17, 18 (1995). We do not believe that this result was intended and suggest that this provision be clarified to eliminate any confusion.

rectors' selection of a fund's auditors.[26] In all other cases, the selection could be made within 30 days before or 90 days after the beginning of a fund's fiscal year. Shareholder ratification currently is required only for funds that hold annual shareholders' meetings. The legislation appropriately would leave the selection of auditors to the board in all cases. If shareholders are dissatisfied with the directors' decision, the shareholders can vote to terminate the auditors at any time.[27]

The legislation would address shareholder voting procedures in "master-feeder" fund arrangements. In a master-feeder arrangement, one or more funds ("feeder" funds) invest solely in the shares of another fund ("master" fund).[28] When a matter is submitted for approval by the master fund's shareholders, the Investment Company Act requires feeder funds to seek voting instructions from their shareholders and vote accordingly ("pass-through voting").[29] This provision seeks to place control of matters that fundamentally affect the master fund's operations and investments in the hands of the feeder funds' shareholders.[30]

Because the master-feeder voting provision initially was enacted to address concerns about unregistered foreign funds investing in and exercising control over U.S. funds, it applies only to unregistered feeder funds.[31] The legislation would recognize that feeder funds' shareholders should have a say in the fundamental decisions affecting the master fund in all cases. Thus, the legislation would extend the Act's voting provision to registered feeder funds as well.[32]

Definition of Majority Vote. The Investment Company Act currently requires certain important matters to be approved by the vote of a "majority of the fund's outstanding shares."[33] Under the Act, the vote of a majority of a fund's outstanding shares means the lesser of (a) the vote of at least 67% of shares present at a meeting, if the holders of more than 50% of the outstanding shares are present at the meeting, or (b) the vote of more than 50% of the outstanding shares.[34] Under this provision, any matter subject to the Act's majority vote requirement must be approved by the holders of more than 33.5% of a fund's shareholders (*i.e.*, 67% of the shares present at a meeting when a majority (more than 50%) of the outstanding shares are present). For purposes of the provision, shares represented by proxy are considered present, regardless of whether the proxies provide voting instructions. The small amount of legislative history on the majority vote requirement suggests that the provision was intended to prevent the holders of a small block of a fund's shares from controlling the fund.[35]

Many funds have advised us of the considerable time they expend and of the costs they incur in seeking the requisite majority votes, particularly when a large number of proxies provide no voting instructions.[36] The legislation seeks to address these difficulties and give shareholders who have provided voting instructions on specific

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[26] Section 2(c) of H.R. 1495 (amending section 32(a) of the Investment Company Act, 15 U.S.C. §80a-31(a)). The proposed amendment also would replace the current timeframes within which directors must select the auditors by codifying the requirements of rule 32a-3 under the Investment Company Act, 17 CFR §270.32a-3, which governs the board's selection of auditors when annual shareholders meetings are not held. In the case of a fund that belongs to a group (or "set") of related investment companies with different fiscal years, the selection could be made within 90 days before or after the beginning of the fund's fiscal year.

[27] Section 32(a) of the Investment Company Act.

[28] This two-tier structure is permitted by section 12(d)(1)(E) of the Investment Company Act, 15 U.S.C. §80a-12(d)(1)(E).

[29] Section 12(d)(1)(E)(iii)(aa) of the Investment Company Act. This provision also allows feeder funds, as an alternative to pass-through voting, to vote their shares in the master fund in the same proportion as the votes cast by the other feeder funds ("echo voting").

[30] *See, e.g.*, SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 316-322 (1966) (discussing the dangers created when control is exercised by a fund holding company) (hereinafter PPI REPORT).

[31] *See, e.g.*, H.R. REP. NO. 1382, 91st Cong., 2d Sess. 23-24 (1970).

[32] Section 2(f) of H.R. 1495 (amending section 12(d)(1)(E) of the Investment Company Act). Because feeder funds that register with the Commission have agreed in their registration statements to provide pass-through voting for their shareholders, the legislation would not impose any additional burdens on registered feeder funds.

[33] *See, e.g.*, Investment Company Act §15(a) (requiring a majority shareholder vote to approve increases in a fund's investment advisory fees); §13(a), 15 U.S.C. §80a-13(a) (requiring a majority shareholder vote to approve certain changes in a fund's investment policy). If the proposed amendment to section 13(a) is adopted, a majority shareholder vote also would be required to approve changes in a fund's investment objective.

[34] Investment Company Act §2(a)(42)(a)-(b), 15 U.S.C. §80a-2(a)(42)(a)-(b).

[35] *See, e.g.*, Jaretzki, *The Investment Company Act of 1940*, 26 Wash.U.L.Q. 303, 316-317 (1941).

[36] Shareholder abstentions often take the form of so-called "broker non-votes." Broker non-votes generally are shares held in record name by a broker for which the broker does not have discretionary voting power or voting instructions from the beneficial owner. While the non-votes are effectively negative votes, they do assist the fund in obtaining a quorum.

matters the right to decide these matters. Thus, the legislation would amend the Act to provide that a matter subject to the Act's majority vote requirement would need to be approved by only a majority of the shares *voting* on the matter at a meeting.[37]

The effect of the amendment would be to reduce significantly the number of shares required to obtain shareholder approval for important matters such as increases in advisory fees and changes in a fund's investment policies. Under the proposed amendment, for example, these matters could be approved by a small percentage of a fund's outstanding shares (*e.g.*, 10.1%) when a relatively small percentage of the shares present at a meeting (*e.g.*, 20%) give voting instructions. In contrast, the Act's existing majority vote provision, as noted above, requires an affirmative vote of more than 33.5% of a fund's outstanding shares.

The Commission acknowledges that the proposed definition of majority vote contained in the legislation is similar to that included in certain state corporation laws.[38] The Commission also recognizes that the new requirement would likely result in funds' incurring lower costs in connection with proxy solicitations. The Commission is concerned, however, that the new definition could in many cases result in a dilution of shareholder voting rights, which the Act historically has deemed most important. We are not aware of any concrete data that demonstrates a systemic lack of interest among fund shareholders in exercising their right to vote on important matters. We would be in a better position to assess this provision if such data were available.

Investment Company Advertising Prospectus. Advertising is particularly important to mutual funds because they continuously offer and sell their shares to the public. Like other public issuers of securities, funds are subject to the advertising requirements of the Securities Act of 1933 (the "Securities Act"). That regulatory scheme, however, has proved to be problematic when applied to fund advertising.

Currently, funds may advertise performance data and other information, so long as the "substance of" that information is contained in the fund's prospectus. These advertisements are subject to liability for false or misleading statements.

As a result of the "substance of" requirement, funds often cannot advertise matters of investor interest, such as policies that a fund will not use derivatives or the effect of economic conditions on the fund's investment policies, since these matters may not have been addressed in the fund's prospectus and related statement of additional information.[39] Funds often attempt to avoid this result by cluttering their prospectus (or the related statement of additional information) with information they may later want to include in advertisements.

The legislation would improve fund advertising by giving the Commission express authority to create a new investment company "advertising prospectus."[40] The amendment would enable funds to use such a prospectus to show performance data and other information unrestricted by the "substance of" requirement. Providing funds with greater flexibility to determine the content of their advertisements should not undermine investor protection; the advertising prospectus generally would be subject to the liability provisions of the Securities Act applicable to prospectuses.[41]

As Chairman Fields noted in introducing the legislation, the new advertising prospectus would bring "a new era of generally improved communications to mutual

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[37] Section 2(g) of H.R. 1495 (amending section 2(a)(42) of the Investment Company Act). The amendment would not change the existing provision in section 2(a)(42) that effectively requires a majority of the fund's outstanding shares to be present at a meeting to constitute a quorum.

[38] *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 2-506 (1993).

[39] Dudley H. Ladd, *Why It's Time to Change the Advertising and Newsletter Rules, in 1995* MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE IV-B-11 (Federal Bar Assoc. and CCH Inc., 1995).

Form N-1A, 17 CFR § 274.11A, the mutual fund registration form under the Investment Company Act and the Securities Act, 15 U.S.C. § 77a *et seq*, incorporates a two part disclosure format consisting of (i) a simplified prospectus, that satisfies the prospectus delivery requirements of section 5(b)(2) of the Securities Act, 15 U.S.C. 77e(b)(2), and (ii) a statement of additional information, available to investors upon request. A fund's advertisement will satisfy the "substance of" requirement if information to be included in fund advertisements (but not otherwise required to be included in the prospectus) is placed in the statement of additional information and incorporated by reference into the prospectus.

[40] Section 3 of H.R. 1495 (creating new section 24(g) of the Investment Company Act).

[41] The advertising prospectus also would be subject to the summary suspension procedures under section 10(b) of the Securities Act, 15 U.S.C. § 77j(b), permitting the Commission to take prompt action to prevent the use or distribution of materially false or misleading advertisements. The Commission also could require advertising prospectuses to comply with the same standards for calculating performance information included in current advertisements. *See* rule 482 under the Securities Act, 17 CFR § 230.482.

fund investors."[42] The Commission agrees with this assessment and supports this initiative. The legislation also would further the Commission's efforts to develop shorter, more "investor-friendly" disclosure documents, since advertisements would no longer be tied to the contents of a fund's prospectus.[43] The proposal also may increase the amount of information about funds that reaches investors, which should, in turn, benefit investors and funds.

Books, Records and Inspections. Because the success of the investment company industry depends greatly on public trust, both the fund industry and the Commission agree on the importance of the Commission's inspections program.[44] As the Commission and others have noted to Congress repeatedly over the recent past, the ability of the Commission to conduct fund inspections has been affected by a scarcity of resources.[45] As investors have entrusted more and more of their savings to mutual funds, as the number and type of funds have proliferated, and as funds have invested in increasingly complex financial instruments, including derivatives, the Commission's resources to fulfill its responsibilities as a law enforcement agency have lagged far behind. The Commission has itself attempted to address this problem by utilizing its limited resources more efficiently. In its latest effort, the Commission consolidated all of its inspection programs into a new office, the Office of Compliance Inspections and Examinations. By giving our examination process a more unified perspective, we will not only better apply our limited resources, but also strengthen and improve the process.

The Commission believes that more can and should be done to enhance its fund inspections program. The provisions of the legislation relating to books, records, and inspections would assist the Commission in improving and making the program more efficient. The Commission supports these amendments.

The Commission inspects investment companies to evaluate compliance with statutory provisions, assess the accuracy of disclosures made to investors, and review internal control systems. Fund examinations promote regulatory compliance by deterring as well as detecting abuses. Our experience has been that most funds understand the goals and benefits of the inspections program and cooperate fully with requests for information made by the staff conducting inspections.

The Investment Company Act permits the Commission to inspect records that funds are required to maintain under Commission rules.[46] Under the Act, however, the Commission can require a fund to maintain only those records that relate to the fund's financial statements.[47] Many matters that could shed light on a fund's operations and facilitate more comprehensive inspections, however, may not be reflected in records related to the fund's financial statements.

The legislation would reduce the existing limitations on, and further clarify, the Commission's authority to require funds to maintain various records.[48] In so doing, the legislation would make the recordkeeping requirements of the Investment Company Act similar to those applicable to broker-dealers and depository institutions under the Securities Act of 1934 and thereby strengthen the Commission's inspections program.[49] The Commission could use its rulemaking authority to facilitate examinations of fund transactions that present novel investor protection issues, such as derivative investments, which often are documented in records unrelated to the financial statements.

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[42] 141 CONG. REC. E868 (Apr. 7, 1995).

[43] *See, e.g.*, Arthur Levitt, Chairman, SEC, Remarks at the National Press Club, Washington, D.C. (Oct. 13, 1994).

[44] *See, e.g., Mutual Fund Industry: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103rd Cong., 2d Sess. 49 (1994) (statement of Matthew P. Fink, President, Investment Company Institute).

[45] *See, e.g., 1993 Oversight Hearings, supra* note 8, 55-57 (prepared statement of Arthur Levitt, Chairman, SEC); *See also Mutual Fund Industry: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce* (prepared statement of Matthew P. Fink, President, Investment Company Institute).

[46] Investment Company Act §31(b), 15 U.S.C. §80a-30(b).

[47] Section 31(a) of the Investment Company Act, 15 U.S.C. §80a-30(a); rule 31a-1 under the Act, 17 CFR §270.31a-1.

[48] Section 4 of H.R. 1495 (amending section 31(a) of the Investment Company Act to require investment companies to keep such records as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors). The legislation also would amend section 31(b) of the Act to allow examiners to obtain copies of fund records without seeking a formal order. Consistent with current requirements, the amendments would apply to registered investment companies and certain fund affiliates, including investment advisers and [illegible]cipal underwriters.

[49] *See, e.g.*, sections 17(a) and (b) of the Securities Exchange Act of 1934 ("Securities Exchange [illegible]), 15 U.S.C. 78q(a)-(b).

The legislation seeks to increase the efficiency of the Commission's inspections program by clarifying the Commission's authority to specify the format for maintaining and providing records to the Commission.[50] The Commission expects to use this authority, at least initially, not to require that funds maintain records in a particular medium (e.g., on computer disk), but simply to clarify that the Commission can request that records maintained by funds in a given medium be provided to the Commission in that medium.

The Commission acknowledges that the authority provided under the legislation would enable it to require funds to maintain records in an electronic format. Such a requirement, the Commission submits, could significantly improve the efficiency of the Commission's fund inspections program. Allowing the staff to review fund information electronically prior to commencing on-site inspections, for example, could reduce dramatically the amount of staff time spent at a fund's offices, and thereby lessen regulatory burdens on funds.

The Commission recognizes that the benefits of requiring fund records to be kept in a particular medium must be balanced against the burdens of such a requirement on the fund industry. Moreover, the Commission is acutely aware of the potential costs and difficulties new electronic recordkeeping requirements could create for funds. The legislation acknowledges these potential concerns by expressly requiring that the Commission, in exercising its new recordkeeping authority, seek to minimize burdens on small entities. The Commission appreciates that recordkeeping requirements present potential burdens for all funds, large and small, and would exercise this authority with a view to minimizing burdens on all funds. The fund industry in the past has acknowledged that the Commission and its staff have been successful in adapting the Act to "a fast-changing marketplace through rulemaking, exemptive orders and no-action letters."[51] The Commission believes that it can update the Act's recordkeeping requirements in the same spirit.

Reports to the Commission and Shareholders. The significant growth of the fund industry underscores the need for the Commission to be able to monitor fund operations and investment activities. The Commission currently has the authority to require fund reports on a semi-annual or quarterly basis.[52] Under the existing regulatory scheme, the Commission's authority to require prompt reports from funds during times of market stress, for example, is limited. Typically, to obtain such information, the Commission must await the next periodic filings, initiate inspections, or rely on voluntary efforts by the industry.

The legislation would allow the Commission to improve its access to information by authorizing the Commission to specify, by rule, the frequency of fund reporting.[53] The legislation also would make clear that the Commission has rulemaking authority to obtain information on fund portfolios and sales and redemption activity, as well as other information that may help identify particular funds or patterns of events that require closer scrutiny.[54] Thus, rulemaking authority would enable the Commission to adapt the content of fund reports to changing market and industry conditions.

The legislation would broaden the Commission's authority to prescribe the content of annual reports to fund shareholders.[55] The Commission would be able to require annual reports to contain pertinent investor information, such as a fund's invest-

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[50] Section 4 of H.R. 1495 (creating new section 31(c) of the Investment Company Act).

[51] *1993 Oversight Hearings, supra* note 8, 70 (testimony of James S. Riepe, Managing Director, T. Rowe Price Associates, Inc.)

[52] Sections 30(a) and (b) of the Investment Company Act, 15 U.S.C. §80a-29(a), -(b). *See also* rule 30b1-1 under the Act, 17 CFR §270.30b1-1 (requiring funds to file semi-annual reports).

[53] Section 5 of H.R. 1495 (amending section 30(b) of the Investment Company Act). The Commission has similar authority with respect to registered broker-dealers under section 17(a) of the Securities Exchange Act, 15 U.S.C. §78q(a) (authorizing the Commission to require broker-dealers to make and disseminate a broad range of reports). *See also* section 17(h)(2) of the Securities Exchange Act, 15 U.S.C. §78q(h)(2) (authorizing the Commission, in times of adverse market conditions, to require registered broker-dealers to file reports concerning the financial and securities activities of their associated persons) and note 49 *supra*.

[54] Section 5 of H.R. 1495 (amending section 30(b) of the Investment Company Act to give the Commission rulemaking authority to request information that is necessary or appropriate in the public interest or for the protection of investors). Existing section 30(b) of the Act limits fund reporting to information that is necessary to keep a fund's registration statement current.

[55] Section 5 of H.R. 1495 (amending section 30(d) of the Investment Company Act, 15 U.S.C. §80a-29(d), which currently limits the Commission's authority to prescribing the content of financial statements contained in annual reports).

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ment activities underlying its recent performance results.[56] This, in turn, may help reduce the length and complexity of fund prospectuses and better inform investors of the risks of their fund investments.

As in the case of recordkeeping requirements, the Commission is sensitive to the costs and burdens that additional reporting requirements might impose on funds. The Commission would exercise its new authority under this provision cautiously. The Commission believes that the goals of more efficient oversight by the Commission, and more informative shareholder reports, are not inconsistent with reducing regulatory burdens on the industry.

The Commission supports both amendments.

Unified Fee Investment Company. As the investment company industry has grown and diversified, the variety of fees for services related to fund operations also has increased. The legislation would provide sponsors with the alternative of offering a mutual fund, termed a unified fee investment company or "UFIC," that would charge a single fee.[57] The proposed single fee structure could facilitate cost comparisons among funds, which, in turn, could increase competition and place downward pressure on fee levels. The Commission supports the UFIC concept.

The UFIC envisioned by the legislation would generally have the same corporate structure as that of a typical mutual fund, including a board of directors. With limited exceptions, all UFIC expenses would be paid from the unified fee or from the investment manager's own resources.[58] The fee would be set by the fund's investment manager, which could impose no additional sales charges or other fees. To make investors aware of the fee paid in connection with their UFIC investment, the legislation would require the fee to be prominently disclosed on the cover of the fund's prospectus. The fee could not be changed more frequently than annually and only upon adequate notice to shareholders. In addition, to provide a check on the amount of the unified fee and the manager's control over the UFIC's operations, the legislation would require at least two-thirds of a UFIC's board of directors to be independent. The directors would be responsible for approving the management contract and other key service arrangements.[59] While we cannot say whether investors and the fund industry will embrace the UFIC concept, the Commission believes that they should have the opportunity to do so.[60]

The UFIC structure contemplated by the legislation preserves many of the Act's corporate governance concepts. Some in the fund industry have suggested an approach for UFIC-type arrangements that is premised on the belief that the respective rights and obligations of investors and fund managers should be governed by a contract rather than the corporate governance structure currently required by the Act.[61] Under this approach, a UFIC-type company would not have a board of directors, its shareholders would not have voting rights, and its management would not be subject to the fiduciary duty provisions of the Act.[62]

These issues may need to be addressed for the UFIC concept to be viable. It may be appropriate to develop practical substitutes for the oversight provided by fund boards of directors and the other investor protection features of the Act's corporate governance provisions. The Commission believes that exploring alternatives would

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[56] Such rulemaking would be particularly beneficial for the shareholders of closed-end funds who, unlike their mutual fund counterparts, receive updates on fund activities only in the form of annual reports.

[57] Section 6 of H.R. 1495 (adding new section 66 of the Investment Company Act to give the Commission rulemaking authority to implement the UFIC proposal by exempting open-end funds from the Act's current provisions governing fund management and distribution fees).

[58] A UFIC would pay its own taxes, interest and brokerage commissions associated with its portfolio transactions, and fees of the fund's independent directors and experts engaged on their behalf. UFICs also would pay any extraordinary expenses associated with their operations, so that the unified fee could be based on reasonable expectations of fund operating expenses.

[59] The board would have to determine that the unified fee paid under the management contract is not unconscionable or so grossly excessive as to constitute a waste of corporate assets under state law.

[60] At least one fund complex, Twentieth Century Investors, Inc., currently imposes a single fee.

[61] *See* Protecting Investors Report, *supra* note 7, at 282-288; Stephen K. West, Address at the General Meeting of the Investment Company Institute (May 1, 1980) (suggesting simplified governance and fee arrangements would be more flexible for a manager and more comprehensible to investors). It has been suggested by others, however, that the UFIC corporate governance requirements included in the legislation should be strengthened. Pat Regnier, *If It Ain't Broke*..., 25 Morningstar Mutual Funds 8, Aug. 18, 1995, at S2.

[62] Section 36(b) of the Act, 15 U.S.C. § 80a-35(b), imposes a fiduciary duty on a fund's investment adviser with respect to the amount of compensation the adviser and its affiliates receive :he fund and its shareholders. While the legislation contemplates that a UFIC would not to section 36(b), it also requires that the UFIC's board determine that the compensa- o the UFIC manager is not unconscionable or grossly excessive.

be worthwhile, and looks forward to working with the Subcommittee if it determines to further refine this proposal.

Investment Company Names. In selecting mutual funds, investors often focus on a fund's name as a way of determining its investment objective and level of risk. As some commentators have suggested, relying solely on a fund's name in making an investment may prevent investors from fully appreciating the fund's risks and objectives.[63] To address this issue, the Commission has undertaken a number of initiatives to educate investors about the pitfalls of relying on a fund's name in making an investment decision.[64] The Commission also believes that investor protection concerns may be raised by fund names that, for example, include the word "government," "guaranteed," or "insured." Such names may in some cases cause investors to conclude, incorrectly, that their investments are guaranteed by state or federal governmental authorities.

Although the Investment Company Act currently prohibits funds from using misleading or deceptive names, the means provided in the Act for enforcing this provision are antiquated. The Act requires the Commission to find, and declare by order, that a fund's name is deceptive or misleading, and then bring an action in federal court to enjoin the use of the name.[65] This process is cumbersome and has been rarely used by the Commission. The legislation would give the Commission a more effective and efficient means of addressing deceptive or misleading fund names by authorizing the Commission to address these practices by rule.[66] The Commission supports this amendment.

Private Investment Companies and Qualified Purchaser Pools. The Investment Company Act excepts from registration and regulation under the Act any fund that has no more than 100 investors and does not publicly offer its securities.[67] The 100 investor limit and the public offering prohibition both are designed to ensure the private nature of the fund so that federal regulation is not warranted. The legislation would simplify the "private" fund exception, as well as create a new exception from Investment Company Act regulation for funds whose shareholders are all highly sophisticated investors.

Amendments to the Private Fund Provision. The legislation would simplify the complex test now used to calculate a private fund's 100 investor limit.[68] Under the current test, a private fund may have to include within the 100 investor limit the shareholders of certain corporate investors in the fund.[69] In practice, private funds avoid application of this "look through" provision by restricting corporate investments to less than 10% of their securities. The legislation would simplify the private fund exception by no longer requiring private funds to count the underlying shareholders of their corporate, non-investment company investors under any circumstances. Such investors are unlikely to be mere conduits intended to enable a private fund to have indirectly more than 100 investors. The legislation, however, would effectively limit participation in private funds by a registered investment company, another private pool, or a new qualified purchaser pool (discussed below) to no more than 10% of any one private fund's voting securities.[70]

Qualified Purchaser Pool Provision. The legislation would create a new exception from registration and regulation under the Act for investment pools whose shareholders are all highly sophisticated, "qualified purchasers." [71] These new pools would

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[63] *See* Carole Gould, *When the Title Doesn't Tell the Story*, N.Y. TIMES, Jan. 22, 1995, at 14.

[64] Chairman Levitt has addressed fund names in a number of "town meetings" with investors. *See, e.g.*, Arthur Levitt, Chairman, SEC, Remarks at Investors' Town Meeting at the Houstonian Hotel, Houston, TX (Apr. 12, 1995).

[65] *See* section 35(d) of the Investment Company Act, 15 U.S.C. § 80a-34(d).

[66] Section 7 of H.R. 1495 (amending section 35(d) of the Investment Company Act). The judicial enforcement provision in current section 35(d) would be eliminated since the Commission could use the cease and desist authority in section 9(f) of the Act, 15 U.S.C. § 80a-9(f), and the general enforcement authority in section 42(d) of the Act, 15 U.S.C. § 80a-41(d), to preclude the use of a misleading fund name.

[67] Investment Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(1).

[68] Section 8(a) of H.R. 1495 (amending section 3(c)(1) of the Investment Company Act).

[69] The requirement to "look through" certain corporate shareholders to their underlying investors applies when a corporate shareholder acquires 10% of a private fund's securities and also has invested 10% of its assets in one or more private funds.

[70] *See also infra* note 71 regarding additional technical amendments.

[71] Sections 8(a) and 8(b) of H.R. 1495 (creating new section 3(c)(7) of the Investment Company Act as the exception for qualified purchaser pools, and new section 2(a)(51) of the Act that would define the term "qualified purchaser" for purposes of the new provision).

Section 8(a) of H.R. 1495 also would make technical amendments to sections 3(c)(1) and 3(a)(3) of the Investment Company Act, 15 U.S.C. §§ 80a-3(c)(1), -(3)(a)(3). These include restrictions on the acquisition of a registered fund's securities by private and qualified purchaser pools

not be prohibited from publicly offering their securities or required to limit the number of their investors.[72] The qualified purchaser alternative would recognize that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections.[73] These investors generally can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.

The legislation would define a qualified purchaser as any natural person who owns at least $10 million in securities, or any person (*e.g.*, an institutional investor) that owns and manages on a discretionary basis at least $100 million in securities.[74] The Commission would be able to adopt rules governing the proposed $10 million and $100 million statutory standards.[75]

The definition of qualified purchaser under the legislation differs from approaches previously considered by this Subcommittee. Under the proposal recommended by the Commission and introduced in both Houses of Congress in 1992, the Commission would have had sole responsibility to specify, by rule, those persons eligible to invest in qualified purchaser pools.[76] A similar proposal subsequently considered by the Congress contained the $10 million and $100 million standards, but would have given the Commission rulemaking authority to define additional persons as qualified purchasers.[77] This approach would have codified standards of financial sophistication and also would have enabled the Commission to respond to changing financial conditions or take other appropriate action based on its administrative experience with the qualified purchaser exception. In defining any new class of qualified purchasers by rule, the Commission would have been required to consider factors such as the participants' sizeable net worth, extensive knowledge and experience in financial matters, substantial amount of assets owned or under management, and relationship with the issuer.

The Commission believes that the preferable approach in crafting a qualified purchaser exception from the Act would be to provide the Commission with rulemaking authority to define the class of investors eligible to participate in the new pools. The Commission understands that the qualified purchaser exception is designed only for highly sophisticated investors, and would support incorporating standards in this provision that would limit its authority to define additional classes of qualified purchasers. Nonetheless the Commission recognizes that Congress may determine that the Commission should not have this authority, and supports this amendment even in the absence of such authority.

Proposed Provisions and Hedge Funds. Some commentators have suggested that the principal effect of the proposed changes to the Act's private fund exception and the proposed qualified purchaser pool exception would be to provide additional relief

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and a provision that would prevent investment companies from avoiding regulation under the Act by establishing private funds or qualified purchaser pools.

[72] The Commission anticipates that, although they would not be prevented from conducting registered offerings under the Securities Act, these pools would be unlikely to conduct such offerings in view of the sophisticated nature of their investors. *See* the "private offering" exemption in section 4(2) of the Securities Act, 15 U.S.C. §77d(2), and the related safe harbors of Regulation D thereunder.

[73] This approach is consistent with other federal securities law provisions that are based, in part, on the financial sophistication of investors. *See* section 4(6) of the Securities Act, 15 U.S.C. §77d (accredited investors), rule 144A under the Securities Act, 17 CFR §230.144A (qualified institutional buyers), and rule 205-3 under the Investment Advisers Act of 1940, 17 CFR §275.205-3 (sophisticated clients).

[74] Since *all* pool participants would have to be highly sophisticated, any time an institutional purchaser (*e.g.*, an investment adviser) invests on behalf of another person (*e.g.*, an individual client or an investment partnership) that person would also have to meet the qualified purchaser standard.

[75] The Commission could use its rulemaking authority, for example, to determine the types of securities eligible for consideration in satisfying the $10 million and $100 million securities tests, when securities under the discretionary management of a subsidiary could be considered those of the parent, or the circumstances under which the partners of an investment partnership would not meet the qualified purchaser standard.

[76] *See* The Small Business Incentive Act of 1992, S. 2518, 102d Cong., 2d Sess. (1992); H.R. 4938, 102d Cong., 2d Sess. (1992).

[77] *See* The Small Business Incentive Act of 1993, S. 479, 103d Cong., 1st Sess. (1993); The Small Business Incentive Act of 1994, H.R. 4858, 103d Cong., 2d Sess. (1994). According to the Senate report, the $10 million and $100 million eligibility standards were included in response to concerns expressed by the Investment Company Institute regarding participation in the new pools by unsophisticated investors. SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, SMALL BUSINESS INCENTIVE ACT OF 1993, S. Rep. No. 166, 103d Cong., 1st Sess. 8-9 (1993).

from the Act for "hedge funds."[78] Many other types of pooled vehicles, however, use the existing private fund exception and could use the new exception contained in the legislation. These investment pools include venture capital funds, acquisition vehicles, and structured financing mechanisms.

It is difficult for the Commission to assess the potential effects that the legislation will have on hedge funds. The term "hedge fund" has come to be used to refer to a variety of pooled investment vehicles that are not registered under the federal securities laws and are therefore not subject to the reporting obligations applicable to public corporations, investment companies, or broker-dealers.[79] Hedge funds typically are operated to comply with the private investment company exception so that they will be exempt from regulation under the Investment Company Act. Interests in hedge funds typically are sold privately to sophisticated, high net worth individuals in ways that do not require registration of the interests under the Securities Act.[80] Thus, no precise figures are available regarding the number of hedge funds that are active in U.S. markets or the total value of assets under their management.[81] The Commission receives limited information regarding the activities of various large market participants, including some hedge funds, through reports filed in connection with the acquisition of certain equity securities issued by publicly traded companies, and reports filed by managers exercising investment discretion over accounts having $100,000,000 in equity securities.[82] This information, however,

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[78] *See Small Business Incentives: Hearings on S. 479 Before the Subcomm. on Telecommunications and Finance of the House Energy and Commerce Comm.*, 103rd Cong., 2nd Sess. (1994).

[79] The term "hedge fund" is not defined or used in the federal securities laws, and has no precise legal definition. The relatively scarce information publicly available about hedge funds suggests that, like other market participants, they vary widely in size, trading strategies, degrees of leverage, and market influence. Some control relatively small amounts of capital and, like many individual investors, pursue conservative buy and hold strategies. Others are more active, using investment techniques such as arbitrage, leveraging, and hedging. These more active hedge funds also trade in a broad range of financial products, including equities, government securities, commodities, financial futures, options, foreign currencies, and derivatives.

[80] *See supra* note 72. Hedge funds also claim an exclusion from registration as securities dealers under section 15(a) of the Securities Exchange Act, 15 U.S.C. §78o(a), based on the "trader" exception to the definition of "dealer." In general, a trader is an entity that trades securities solely for its own investment account and does not carry on a public securities business, while a dealer buys and sells securities as part of a regular business, deals directly with public investors, engages in market intermediary activities, and also may provide other services to investors. *See, e.g.*, Davenport Management, Inc. (*pub. avail.* Apr. 13, 1993); Louis Dreyfus Corp. (*pub. avail.* July 23, 1987).

[81] A recent article about hedge funds stated that "[t]here are at least 1,500 U.S. hedge funds, with some estimates running as high [as] 3,000—about the same number of mutual funds that were in existence in 1981." Jaye Scholl, *Hedge Funds Abhor a Vacuum*, Barron's, July 10, 1995, at 16. Older press accounts give significantly lower estimates of the number of hedge funds. Kate Rakine & Helen Dunne, *Burnt Fingers on Passing the Buck in the Hedge Fund Thicket*, DAILY TELEGRAPH, Mar. 5, 1994, at C1 (reporting that there are 800 hedge funds with $75 billion in assets under management); Sara Webb & Tracy Corrigan, *Hedge Funds Hog the Limelight*, FIN. TIMES, Mar. 5, 1994, at 10 (reporting that there are hundreds of hedge funds, many of which have $2 million or less in assets under management); Earl Gottschalk, *Look Before Taking Leap Into Hedge Funds*, WALL ST. J., Jan. 7, 1994, at C1 (reporting that there are 800 to 1,000 hedge funds with $40 billion in assets under management).

Several recent press reports also have indicated that certain larger hedge funds are returning assets under management to investors. Peter Truell, *Hedge Fund Returns Cash to Investors*, N.Y. TIMES, June 9, 1995, at D3; Laura Jereski, *Kovner, Surprising Wall Street, Is Disbanding U.S. Hedge Fund*, WALL ST. J., June 9, 1995, at C1.

[82] Section 13(d) of the Securities Exchange Act, 15 U.S.C. §78m(d), and Rule 13d-1(a) (17 CFR §240.13d-1(a)) thereunder require any person, who after acquiring directly or indirectly the beneficial ownership of any security registered under section 12 of the Securities Exchange Act, is directly or indirectly the beneficial owner of more than 5% of such class, to file a Schedule 13D with the Commission within 10 days of such event. Certain persons, however, including registered broker-dealers, banks, insurance companies, registered investment companies, registered investment advisers, and employee benefit plans, that acquire such holdings in the ordinary course of business and without the purpose of changing or influencing the control of the issuer, are eligible to file a short form statement on Schedule 13G within 45 days after the end of the calendar year in which the reporting obligation arises. Rule 13d-1(b)(1) under the Securities Exchange Act, 17 CFR §240.13d-1(b)(1).

Section 13(f) of the Securities Exchange Act, 15 U.S.C. §78m(f), requires "institutional investment managers" exercising investment discretion with respect to accounts having $100,000,000 or more in equity securities on the last trading day of any month to file a Form 13F with the Commission. This information, however, only is required to be filed on a quarterly basis. "Institutional investment manager" is defined to include any person (other than a natural person) investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.

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does not reveal much about the trading activities of hedge funds or ways in which they raise capital.

Because hedge funds are, by their very nature, not highly visible participants in the capital markets, the Commission is not in a position to assess the opportunities for growth that the legislation would afford hedge funds. Along with other investment pools, a hedge fund would be able to rely on either the amended private investment company exception or the new qualified purchaser provision. A hedge fund using the new qualified purchaser exception would be limited to investors that meet the legislation's high standards of financial sophistication, and a hedge fund relying on the amended private investment company provision would remain limited to 100 investors and could not publicly offer its securities.

Funds of Funds. A "fund of funds" arrangement arises when one fund (the "acquiring fund") invests substantially all of its assets in other funds (the "acquired funds"). Certain types of fund of funds have been popular with investors recently, it would appear, because they offer investors a way to diversify their fund investments through a single, professionally managed portfolio.[83] In order to operate, however, these funds have generally required exemptive relief from the Investment Company Act because the Act, with certain exceptions, places restrictions on a fund's investment in other funds.[84] Under the Act, a fund may not acquire more than 3% of another fund's voting stock, and may not invest more than 5% of its assets in any one fund. In addition, a fund's investments in all other funds may not exceed, on an aggregate basis, more than 10% of its assets.

These restrictions were enacted in 1970, and were intended to protect investors from the potential harm resulting from complicated pyramid structures.[85] In particular, Congress and the Commission were concerned, at that time, that fund of fund arrangements could result in excessive layering of fees and present opportunities for abuse of control arising from the concentration of voting power in the acquiring fund.[86]

The Commission has recently granted individual exemptions from the Investment Company Act's restrictions to fund of fund arrangements that operate under conditions designed to address the concerns upon which the restrictions were premised.[87] The legislation would incorporate certain of these conditions and would enable fund of fund arrangements that comply with those conditions to be offered without obtaining prior exemptive relief from the Commission.

The legislation would exempt mutual funds from the Investment Company Act's restrictions on fund investments if they invest substantially all of their assets in other mutual funds in the same group, or "family," of funds.[88] The legislation would

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Reporting also is required under the Large Option Position Reporting ("LOPR") system, established in 1973 by the various options exchanges. The LOPR system requires reporting by broker-dealers to the exchanges of the establishment and net change in large option positions, and is designed to monitor compliance with exchange position limits and to detect excessive short uncovered option positions. Likewise, the Commodity Futures Trading Commission requires large position reporting identifying the positions of large traders in specific futures contracts. See section 4i of the Commodity Exchange Act, 7 U.S.C. § 6i.

[83] Two funds of funds that commenced operations in 1985 and 1989, respectively, for example, have aggregate assets of approximately $6.3 billion and approximately 400,000 aggregate shareholder accounts. *See infra* note 87. The Commission recently has received applications from several other funds requesting exemptive relief to operate as funds of funds. It appears that the popularity of these arrangements is part of a trend in which investors are increasingly interested in asset allocation products, such as wrap accounts and mutual fund wrap accounts. In a wrap fee program, the client typically is provided with portfolio management, execution of transactions, asset allocation, and administrative services for a single fee based on assets under management. Mutual fund wrap fee programs provide similar services, but the client account is invested only in mutual funds.

[84] Sections 12(d)(1)(A)-(C) of the Investment Company Act, 15 U.S.C. § 80a-12(d)(1)(A)-(C). Sections 12(d)(1)(E) and (F) provide exemptions from these restrictions for funds that invest only in one other fund (*e.g.*, master-feeder arrangements, discussed at *supra* note 28 and accompanying text) and for funds that do not acquire more than 3% of the total outstanding stock of any one other fund and do not charge sales loads of more than 1½%.

[85] *See* H.R. REP. NO. 1382, 91st Cong., 2nd Sess. 10-11, 23-35 (1970); PPI REPORT, *supra* note 30, at 322. As originally enacted in 1940, section 12(d)(1) contained certain prohibitions on fund of fund arrangements. The 1970 amendments provided for additional prohibitions. H.R. REP. NO. 1382.

[86] *See* H.R. REP. NO. 1382; PPI REPORT, *supra* note 30, at 322.

[87] *See, e.g.*, T. Rowe Price Spectrum Fund, Inc., Investment Company Act Release No. 21371 (Sept. 22, 1995) (Notice), Investment Company Act Release No. 21425 (Oct. 18, 1995) (Order); Va[illegible]ard Star Fund, Investment Company Act Release No. 21372 (Sept. 22, 1995) (Notice), In-[illegible]nt Company Act Release No. 21426 (Oct. 18, 1995) (Order).

[illegible]ection 9(2) of H.R. 1495 (adding new section 12(d)(1)(G) to the Investment Company Act). [illegible] legislation would define a "group of investment companies" as any two or more mutual

allow an acquiring fund to invest in short-term paper so that the fund has sufficient liquidity to meet redemption requests. To prevent overly complex arrangements, however, an acquiring fund would not be permitted to invest in another fund of funds.[89]

To prevent the payment of excessive sales loads and other distribution-related charges in the fund of funds context, the legislation would limit the sales charges that may be imposed (directly or indirectly) on an acquiring fund's investors. The legislation contains two alternatives that would address sales charges. The first alternative would allow either the acquiring or the acquired fund, but not both, to impose sales charges. The second alternative would allow sales charges to be imposed by both the acquiring and acquired funds so long as the charges, taken together, comply with applicable rules of the National Association of Securities Dealers, Inc. concerning sales charges.[90] The Commission believes that the first alternative, which would restrict sales charges to one fund (acquiring or acquired), is unnecessarily restrictive. The second alternative would address excessive sales charges while providing flexibility to the acquiring fund, the acquired fund, or both, to assess sales charges.

The legislation would not address other fees that may be charged, directly or indirectly, to an acquiring fund's investors, but we do not believe that it is necessary for the legislation to do so. The Commission would be able to use its authority under the Securities Act to require full disclosure about the acquiring fund's structure. The Commission, for example, would be able to address the potential for excessive layering of advisory fees by requiring an acquiring fund to disclose in the prospectus fee table the cumulative advisory fees paid by the acquiring and acquired funds.

The legislation would require an acquiring fund to comply with the pass-through and echo voting procedures that the legislation would make applicable to registered feeder funds.[91] In its recent exemptive orders, however, the Commission has not required an acquiring fund to use these voting methods. The Commission believes that specifying the voting method in this manner is unnecessary for investor protection and that the acquiring fund's board of directors is in the best position to select the type of voting procedure to be used by the acquiring fund.[92] The Commission, therefore, recommends that the provision regarding voting be deleted from the legislation.

Under the legislation, the Commission would have the authority to adopt rules to fill any gaps in investor protection or to address any abuses arising in connection with the new fund of funds exemption. The legislation also would give the Commission the authority to exempt by rule or order any person, security or transaction from the Investment Company Act's restrictions on fund of fund arrangements.[93] The Commission, for example, could use this authority to issue a rule exempting arrangements that involve funds that are not part of the same fund family or that otherwise do not fall within the new exemptive provision. The legislation would expand the scope of the Commission's existing exemptive authority under the Investment Company Act by permitting it to grant relief from the Act's restrictions on fund of fund arrangements if and to the extent the exemption is consistent with the protection of investors.[94] This new authority would clarify that the Commission

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funds that hold themselves out to investors as related companies for purposes of investment and investor services.

[89] New section 12(d)(1)(G)(iv) would require an acquired fund to have a fundamental policy prohibiting it from investing in the shares of other funds in reliance on paragraphs (F) or (G) of section 12(d)(1).

[90] Section 26(d) of the NASD Rules of Fair Practice addresses investment company sales charges. NASD Manual (CCH) ¶ 2176.

[91] *See supra* note 29 and accompanying text.

[92] Mandatory pass-through voting could be potentially burdensome for an acquiring fund that invests in a large number of other funds. Additionally, an acquiring fund's board of directors may determine that echo voting procedures (that is, voting the shares of the acquired fund held by the acquiring fund in the same proportion as the votes cast by the acquired fund's other shareholders) would not give the acquiring fund's shareholders adequate participation in matters submitted for shareholder approval by an acquired fund.

[93] Section 9(3) of H.R. 1495 (adding paragraph 12(d)(1)(J) to the Investment Company Act). This authority would extend not only to exemptions from the Investment Company Act's restrictions on fund investments, but also to master-feeder and other fund of fund arrangements allowed under section 12(d)(1). *See supra* note 84.

[94] *See* section 6(c) of the Investment Company Act, 15 U.S.C. § 80a-6(c) (giving the Commission broad authority to exempt, by rule or order, any person from the provisions of the Investment Company Act, if and to the extent that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act).

could place greater emphasis on the costs and benefits resulting from such an exemption.

The Commission supports the proposed fund of funds amendments, although the provisions addressing affiliated fund of funds may not be necessary in view of the approach taken by the Commission in its recent exemptive orders. If this provision is retained, as noted above, we recommend leaving the selection of the type of voting procedures used in these arrangements to the discretion of an acquiring fund's board of directors. The Commission supports the provision that would clarify the Commission's exemptive authority to address other fund of funds arrangements.

IV. CONCLUSION

The Commission appreciates this opportunity to assist the Subcommittee in reconsidering certain provisions of the Investment Company Act. The Commission strongly supports the Subcommittee's goal of improving and modernizing investment company regulation. The Investment Company Act has served investors and the fund industry well for many years, but changes can and should be made. The Investment Company Act Amendments of 1995 will improve and modernize the framework of investment company regulation. As this legislation progresses, the Commission stands ready to work with the Subcommittee and its staff to meet our shared goals of protecting investors and fostering the successful, efficient, and safe operation of the fund industry.

Mr. FIELDS. You were almost as brief as people giving their opening statements.

We appreciate that statement very much and also appreciate the fact that you and Chairman Levitt have worked with this subcommittee not only on this legislation but in other matters and also appreciate many of the reforms that are coming from the Commission. I think Chairman Levitt is doing a great job.

Let me ask you specifically, while I was going over your testimony last night on page 9 of your testimony, I don't know if you have your full testimony there with you but, at the top of the page, you talk about—and I am not going to read the entire sentence, it is in the first paragraph. We have concerns about the potential effects of an amendment that would change the vote of fund shareholders required to approve certain actions taken by a fund.

What are your concerns and what are the actions that you are particularly concerned with?

Mr. BARBASH. You refer to a proposal in the legislation to change the definition of "majority vote" that is currently in the Investment Company Act. That majority vote provision requires a certain vote to be made by fund shareholders on certain matters such as, for example, approving an advisory agreement.

Under the Investment Company Act as currently written, the majority vote provision has the effect of requiring at least 33.5 percent of the outstanding voting securities of the fund's shareholders to vote in favor of a particular measure for the measure to be adopted and made applicable to the fund.

The proposal would change the voting requirement and require that there be a quorum, a majority of the outstanding shares at every meeting. If there is a quorum present, the vote required to pass a matter would be a majority of those shareholders voting on a particular matter. The problem that the investment company industry has experienced recently is that many shareholders vote by proxy or appear at the meeting by proxy but don't vote on specific matters. The result is that you could have a quorum, because the requisite number of outstanding shares are present at the meeting, but their nonvote on a specific matter is counted as a negative vote

under the majority vote provision of the Investment Company Act. This makes it much more difficult to obtain the required vote.

We are concerned that the proposal would take the effective vote for approving certain matters from 33.5 percent of outstanding shares down to some significantly lower number. For example, if you had a situation where only 20 percent of the fund's outstanding shares were present and voting on a particular matter, that would mean just over 10 percent of the aggregate of the fund's shareholders could approve a significant matter such as an investment advisory agreement.

We are concerned, given the historical importance of shareholder voting to the Investment Company Act, that that may be too low a threshold. What would deal with our concerns, I think, is a greater showing that shareholders do not care about the vote. We are not clear that fund shareholders generally don't care about their voting rights. If they do they may feel that the effect of this provision would be to dilute an important protection.

Mr. FIELDS. I think, conceptually, philosophically, many of us would agree with you but it does seem that there is a problem with what has been called the broker nonvote. I guess what we would be very interested in is if you have any additional comment that you might give the subcommittee on this particular matter.

Mr. BARBASH. It is clear that the broker nonvote is a problem. It is a situation where brokers are given authority over proxies but under existing rules don't have the authority to vote the proxies in favor of the proposal. The shares reflected by the broker's proxy count toward meeting the quorum requirement but can't be used in support of a particular matter.

We acknowledge the existence of this problem. Indeed, we would acknowledge that some of the trends in the industry may make broker nonvoting more of a problem. Some of the brokerage firms have created so-called no-load investing programs and, as part of that, they tend to hold more proxies. I think that has the potential in the future to cause more of a problem for the industry.

As I was saying before, however, we are not sure whether there is data that suggests that shareholders no longer care about voting. And before we could get over our concerns, I think we would need more information about shareholder views on the voting provisions.

Mr. FIELDS. Again, I will be very solicitous in asking for any additional input that the Commission might have.

The mutual fund industry has been very successful in remaining relatively scandal free and in avoiding, you know, widespread investor panic even in falling markets. How have mutual funds' internal audit and compliance procedures helped to limit scandals and problems that might affect investor confidence?

Mr. BARBASH. It is clear that many funds in the industry have very substantial compliance programs and the regulatory system contemplates that funds will set up systems. In fact, many funds do have systems. As a general matter, given the history of the industry, one may presume that these systems have been a successful compliance tool for many funds.

The fund industry through the Investment Company Institute has suggested supplementing existing systems by putting forth to us a proposal for a Commission rule that would mandate that

funds create internal compliance systems. We think that is a good initiative. We have been working on, and would expect at some point in the near future to be coming out with, our own proposal building on the industry's proposal.

Mr. FIELDS. Thank you very much.

The Chair now recognizes the gentleman from Massachusetts, the distinguished Ranking Member, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Mr. Barbash, what are your greatest concerns about the mutual fund industry? Where are the problems?

Mr. BARBASH. I would point to two potential problems. One relates to the nature of fund investors. We have seen tremendous growth in the mutual fund area over the course of the last 10 or 15 years. Many investors are new to the fund industry, new to the fund business, new to investing in funds, and we are concerned that they may not fully appreciate what it means to invest and what it means to have an investment in a market that is not continually going up.

That is the underlying rationale for our trying to enhance the ways in which funds communicate with investors, to encourage funds to communicate information in a manner that will be understood by investors. We have also tried to improve investor understanding by concentrating on various investor education initiatives such as brochures and investor "town meetings." Our concern is whether investors know enough about investing.

We are also concerned about increased competition in the industry. We think competition is good. We worry, however, whether competition will cause funds to cut corners, not be as compliance-oriented as they have been in the past.

Mr. MARKEY. And how does the growth of your staff match against the growth of the funds in the country over the last decade or so?

Mr. BARBASH. Clearly, during the course of the last 10 or 15 years, our staff has increased but our staff has not increased to match the growth of the fund business. Within the course of the last 10 or 12 years, our staff has increased 100 percent. We have gone from roughly 200 people involved with the investment company program to 400. That is a significant increase; we acknowledge that.

The fund industry, in terms of assets, has increased almost a thousand percent over the course of the last 10 or 15 years.

Mr. MARKEY. What would the effect of a 10 percent cut in your budget mean in terms of your ability to do your job?

Mr. BARBASH. If we were to face a 10 percent cut, we would review fewer disclosure documents, we would not be able to attend to rulemaking matters as quickly as we would like and our functions generally across the board would need to be cut back.

Mr. MARKEY. We received testimony from one hedge fund that has raised the question of whether the current 100 investor limit can be modified so that some of the hedge fund's own employees could have a stake in the fund. I would like to know whether your own division has ever considered this question and what your view of it is.

Mr. BARBASH. We have not, as yet, had the question presented to us formally. I think we would be receptive to hearing arguments as to why hedge fund employees should be counted or not counted toward the 100 shareholder limit.

Mr. MARKEY. Is there a problem with it? From an initial review of the subject, in terms of aligning the interests of the managers with the interests of the investors, by having them part of the same——

Mr. BARBASH. A question can be raised that if you allow employees to participate in a fund, without regard to the 100 shareholder limit, you may be tilting the balance toward the insiders as opposed to the outside investors. The Investment Company Act exemption, though, presumes that those "outside" investors participating in a hedge fund or private fund can generally fend for themselves so you would have to weigh the concern raised by increased employee participation against whether the outside investors can protect and fend for themselves.

Mr. MARKEY. Now, some written testimony submitted to the subcommittee suggested that the qualified purchaser exemption provided for in the bill could be rendered moot if proposed tax regulations go into effect; specifically it has been suggested that the definition could bolster the IRS's argument for treating private placement partnerships as publicly traded partnerships because the exemption would allow private investment companies to ignore the numerical limit on investors. Do you share that concern?

Mr. BARBASH. I am certainly not a tax expert. I am familiar with that proposed regulation. I believe that that regulation, if it went through the way it is, could impair the usefulness of the section 3(c)(7) exemption because you would have hedge funds effectively being caught up potentially by a 50 person limit.

Mr. MARKEY. I would like to be able to follow up and maybe I could ask a couple more questions if we have a little more time.

Thank you.

Mr. FIELDS. We will do a second round.

The gentleman from Florida.

Mr. STEARNS. Good morning, Mr. Chairman, and good morning to the witness.

I think many of us have bought mutual funds and you got the prospectus and you start to go through it and you see the different fees that are charged and, you know, you realize that some of these mutual funds are using fees to use for advertising and that is now specified and you go through and look at the fees.

Under this bill, please describe how the single fee structure or a unified fee investment company might increase competition and I think that is one of the reasons the committee is looking at it. They are saying, OK, if we just have a unified fee and everyone can understand what that fee is, both the mutual fund company and the customer, then perhaps these fees will start to be competitive and come down and there won't be a structure set in place so that when you go through the Morningstar and read about the no-load versus the load fund and within the no-load they are using the 12(b), is it the 12(b), and all those things.

Describe how a unified fee might bring the whole fee structure down.

Mr. BARBASH. The unified fee proposal would provide the ability for a mutual fund to operate with a single fee. If that type of arrangement were to be undertaken by many funds, it might allow a clearer representation of the total fees charged by a fund and that could facilitate greater across-the-board comparisons of fund fees. You referred to different types of fees that are assessed in the mutual fund business——

Mr. STEARNS. Even within the no-load area, which a lot of people say, gee, I have a no-load fund when actually what they don't realize within the no-load structure there are two or three fees that the company and directors can use to expense and the customer thinks he has a no-load fund.

Mr. BARBASH. That's absolutely right. The traditional names, "load" and "no-load" funds, as time has progressed, really don't have as much meaning as they did maybe 10, 15, 20 years ago because of the different kinds of fees that are assessed. If an investor is faced with these different fees, he or she has a fairly imposing task trying to figure out what the total cost is of investing in one fund versus another fund.

The simplified fee proposal is designed to get at that problem by enabling funds to charge just one level of fee that could then be compared. Whether, in fact, the proposal is workable, though, depends on the number of funds that have the incentive to adopt this kind of arrangement. Right now, it is possible for funds to have single fees. There is at least one fund group that has a single fee. One of the questions is whether the legislation could be enhanced so as to cause more funds to want to use this methodology. I think that is the issue before us all.

Mr. STEARNS. Just to be a devil's advocate here, for example, if a mutual fund like Magellan or let's say Fidelity and Vanguard, won't they have an advantage in charging a lower fee than a small fund in competing if their unified fee is worked out?

Mr. BARBASH. It is true, generally, that startup funds do have startup costs, and may have to charge higher fees to deal with the cost of establishing themselves in the fund business. That is a potential issue. Over time, that problem can be worked out as fund sponsors get more assets under management. But you are correct, that can be a potential problem.

Mr. STEARNS. You could almost argue the other side of it, that the small business had lower overhead but, of course, when you get the larger sums of money, $10- to $15 billion and you are competing with a fund that is $200 million, then the unified fee structure is a lot less for the large one.

Mr. BARBASH. Startup funds do face sizable costs. More and more, the industry has become service-oriented and has prided itself in providing shareholders with various services. Those services are costly to provide.

Mr. STEARNS. Why should the board of directors of such a company be liable for evaluating whether the fees charged by that company are excessive if the point is to give investors the tools they need to make that determination themselves?

Mr. BARBASH. The theory behind that requirement is to use the general corporate governance provisions of the Investment Company Act in a different context. It changes the rules somewhat that

are applicable to fund directors but it is intended to put a certain cap or certain protective device into the mix so that fees will not become excessive.

Mr. STEARNS. Let me just change questions here; I've got a little more time.

You state in your testimony that the existing regulatory scheme which permits the SEC to require funds to file reports on a semi-annual or quarterly basis limits the SEC's authority to require prompt reports from funds during times of market stress. Please describe the extent to which the SEC has sought to obtain information from investment companies during times of market stress and the reasons for which the SEC sought to obtain that information.

Mr. BARBASH. We have, in the past, been faced with different market crises from time to time—when Orange County faced its bankruptcy, for example, or when interest rates turned in 1994 and caused a fair amount of disruptions in certain kinds of mortgage-backed securities. And at that time, in order to fulfill our regulatory mandate, we thought it was necessary to obtain information about what funds were investing in at that particular time.

We have, historically, sought that information not only from the periodic reports that are filed with us but also through inspections, in some instances through enforcement proceedings and in some instances, funds have provided us information voluntarily. We have, in fact, in the past been able to get the information we needed but we are concerned that we don't receive it in any systematic way so as to be able to react and be ahead of the curve as opposed to behind it.

Mr. STEARNS. Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentlelady from Illinois, Ms. Collins.

Ms. COLLINS. Thank you, Mr. Chairman.

Mr. Barbash, one of the things that this bill purports to do is to lift restrictions on the mutual funds investment in other firms. Why was it necessary to limit mutual funds from investing in other funds.

Mr. BARBASH. You are referring to the so-called "fund-of-funds" limitation. That limitation has part of its origin back in the original Investment Company Act but it was most significantly revised in 1970. In general, what happened was during the latter part of the 1960's, you started to see arrangements whereby one particular fund was only a holding company. In other words, it didn't invest in securities directly; what it did was invest in other types of funds. At the time, some of the holding companies, one in particular, had a record of trying to exert pressure on underlying funds and tried to compel certain payments to be made to the holding company and cause the underlying funds to invest one way or another to be more in accord with what the holding company wanted as opposed to what was in the best interests of the shareholders at large of the underlying funds.

The existing restrictions generally were designed in the 1970's to reduce the control that a holding company could have on funds in which it invests. What has happened over the course of the last 25 years is that the holding company structure has been adapted for other purposes. Many fund groups have sought to use it as a way

to provide an asset allocation service. So, for example, if you were going to invest and you didn't feel that you knew enough about funds to know whether you should be 40 percent in this kind of fund and 60 percent in that, you could be offered an interest in a holding company which would allocate assets for an investor with your general investment characteristics.

These kinds of processes, those kinds of arrangements are constrained by the existing fund-of-funds limits. Essentially, what has happened over the course of the last 25 years is that an organizational structure that was a problem in the 1960's and used for not a particularly wonderful purpose is now being used more frequently for a better purpose, one that could help shareholders.

Ms. COLLINS. And the SEC is satisfied that that problem is not sufficient to retain those limitations?

Mr. BARBASH. We have been asked administratively to consider this issue. In the context in which we have been asked, it has been a somewhat easier question. The arrangements we have considered involve a fund sponsor that creates a holding company that invests in the underlying funds that are also managed by the sponsor. Back in the late 1960's you had a holding company investing in unaffiliated funds. We think that the affiliated fund-of-funds structure is easier to deal with from an investor protection standpoint and we have been confident that they could be managed so as not to disadvantage investors. As a result, we approved these arrangements.

Ms. COLLINS. I, like most people, have a mutual fund and I feel that they are very safe, but have no knowledge about how they are supposed to be run because, over the years, mutual funds have been deemed to be fairly reliable. So when you are approached on your job as I and others have to go into a mutual fund, most people readily do that without any more knowledge than I think that I have.

Now, you have expressed a concern about how much investors know and don't know about mutual funds. I am talking about individual, private investors. And you say that you think one way this bill would help is that it would educate them. You also say there would be things like brochures to help educate them. Is that enough?

Mr. BARBASH. Clearly, investors need to come to funds willing to learn, willing to work at investing. Investing is not necessarily easy until you have the proper amount of knowledge. As regulators, we try to facilitate better information being sent to investors, more investor education, and try to assist or support the industry when it creates those kinds of initiatives. But we certainly can't expect that we are going to be able to educate everybody. The investor also has to work at it.

Ms. COLLINS. I see my time is up but I will be back for the second round.

Thank you.

Mr. FIELDS. The gentlelady's time has expired.

The gentleman from Oklahoma, Mr. Coburn.

Mr. COBURN. Thank you, Mr. Chairman.

Thank you for being here. Under the Investment Company Act right now, we can have a company that has under 100 qualified in-

vestors and if under the new plan if a company had clients that did not meet the criteria of qualified or what do we say qualified or a sophisticated investor but wished to take advantage of this new PIC and expand its business, would the company either have to get rid of those people under the 100 person limit or could they, in fact, offer that to both groups and then not come under the SEC in terms of either violating the 100 person rule or the qualified investor rule? How do you all view that and what is their capability to do that?

Mr. BARBASH. The legislation does not formally address that particular issue. If Congress were to accept the new section 3(c)(7) exemption—the sophisticated or qualified purchaser fund—it would be reasonable to assume that Congress meant for a fund sponsor to be able to rely on either or both exceptions, so I believe that, if faced with a question of what a fund sponsor was able to do in that situation, our view would be that a fund sponsor could continue the existing 100 person fund but also have the ability to create a new sophisticated pool.

We would contemplate there would be separate entities as opposed to a combined entity. In other words, there would be two pools that would be able to be run essentially at the same time without impairing the ability of either fund to rely on one of the exemptions, the 100 person or the qualified purchaser exemption.

Mr. COBURN. So they could, in fact, invest in exactly the same investment vehicles and run one under the 100 person, run one under the qualified investor and not be seen as in violation of those two?

Mr. BARBASH. I would think that would be a fair interpretation of what Congress's intent would be in coming up with the new exemption, yes.

Mr. COBURN. Should there be a grandfather clause to allow those that are currently under the 100 person limit, whether they are qualified investors or not, to convert to this PIC? Should we have a grandfather clause for those that are presently under the 100 person limit?

Mr. BARBASH. I am not convinced that you need a grandfather clause. I think that, acknowledging a sponsor could have two funds relying on both exemptions, that is one fund relying on one and the other fund relying on the other, would be sufficient to address that issue.

Mr. COBURN. One other question I had in terms of the legislation that is proposed is the elimination of liability imposition on fund directors. Would you comment on that?

Mr. BARBASH. I am not sure I follow which provision you are referring to.

Mr. COBURN. Well, is there a proposal that would limit the liability?

Mr. BARBASH. There is a provision, the UFIC—the unified fee investment company provision—which would provide that there is a different liability standard for directors in that context as opposed to a traditional mutual fund. It would also give us the ability to provide an exemption from Section 36(b) of the Investment Company Act, which is the provision that governs liability of boards of directors and certain others.

Mr. COBURN. Do you agree that there should be a different standard?

Mr. BARBASH. The theory of the UFIC, where you have one particular fee, may support the idea that the board does not have to be held to the same degree of liability. I think we would contemplate looking at that issue once the UFIC legislation was in effect.

Mr. COBURN. OK. All right, I yield back.

Thanks.

Mr. FIELDS. The gentleman yields back the balance of his time. The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. I thank you, Mr. Chairman.

Mr. Barbash, I am going to bounce around a little bit. I am going to try to fill in a few holes if you would excuse the roller coaster ride here.

First of all, as we have talked about in this subcommittee before, any investment companies, anyone selling securities is prone to have to deal with a crazy quilt of regulations both at the Federal level and 50 different states. What is the SEC's position on dealing with the state blue sky laws?

Mr. BARBASH. As the members of the subcommittee are probably aware, Chairman Levitt gave a speech last week in which he talked about the mutual fund business and how, because the mutual fund industry is subject to stringent regulation at the Federal level, it would seem to be an industry where we might evaluate a different role for the states, that is, whether there is a lesser regulatory role for the states.

I understand that Chairman Levitt is set to testify before this subcommittee sometime in the near future and at that point he may well be able to fill in the details.

To date, we have no formal policy statement on that question. We have traditionally tried to work with the states. We have acknowledged the potential burdens on the industry of dealing with a set of requirements at the Federal level and at the state level.

Mr. KLINK. Have we heard from the states yet? Are there any concerns in regard to the act that is before us?

Mr. BARBASH. We have not.

Mr. KLINK. What is the current confidence level. How would you, and I am asking for an opinion now, what is the current confidence level that people have, do you think, in this country in investing in mutual funds and how would that confidence level change once this bill, as written, would be enacted?

Mr. BARBASH. It is hard to answer those kinds of questions because I think investors are of all sorts. I think, given the in-flow of money to mutual funds, one might presume that investors are fairly confident in the industry. I think the question could come up as to what would happen in a situation where we had a decline in markets over a more extended period of time. That is, what would happen in the level of confidence under those circumstances.

In terms of how the bill would help investor confidence, I think the provision that probably has the greatest potential to help build confidence is the one dealing with advertising. I think the liberalization of the advertising rules would afford the industry the opportunity to provide better information, more background information,

to investors about investing. I think that would be helpful. I think that provision could have the beneficial effect of improving confidence.

The rest of the provisions tend to be more toning up or fine tuning of the Investment Company Act and it is hard to really conclude what they would do for investor confidence.

Clearly, they are all designed not to chip away at the regulatory framework and not to take protection away from investors. It is to enhance the level of protection, reduce burdens when it is consistent with investor protection. So it should be at least neutral if not somewhat supportive of investors in that regard.

Mr. KLINK. Let me just go back to what my colleague Ms. Collins was talking about earlier, the changes in the fund-to-fund that this provision would make.

Clearly from your answer, there was, prior to 1970, a problem. My concern, any time we liberalize something like this is there is somebody out there, some Jesse James of the mutual fund industry, that is going to find a way around this. Are you confident that we are not opening a door here that is not going to allow a revisiting of this problem?

Mr. BARBASH. The fund-of-funds provision is fairly circumscribed. One of its provisions would effectively put into law an approach that we have taken on an individual, case-by-case basis through exemptive orders. That is what I refer to as the affiliated fund-of-funds provision.

The other provision would essentially enhance our exemptive authority, so the burden would continue to be placed on us to evaluate individual fund-of-funds arrangements and conclude that they are in the interest of fund shareholders and consistent with the purposes of the Investment Company Act so it would not be, willy nilly, allowing fund-of-funds to create and multiply.

Mr. KLINK. Mr. Chairman, not being color blind, I see that the red light is on.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Georgia, Mr. Deal.

Mr. DEAL. Thank you, Mr. Chairman.

I would like to ask you a question with regard to the independent directors. As I understand, the proposal is that they would not constitute a majority of the board rather than the current 40 percent requirement. Would you explain to me the review of these advisory contracts at the annual review process that are mandated under the act. Can they not just review these advisory—these investment advisory agreement contracts at that annual meeting? Why is the mandate there? Couldn't they do it otherwise without the mandate?

Mr. BARBASH. The mandate that's in the Investment Company Act that directors look at the advisory agreement on a periodic basis?

Mr. DEAL. Yes.

Mr. BARBASH. The Investment Company Act was adopted at a time when the history of funds in the United States had been such that funds were changing their investments and the amounts of the fees that they were charging their investors on a regular basis. The board of directors provisions were designed to essentially check po-

tential conflicts of interest or serve as an additional check to existing checks in the Investment Company Act on those conflicts of interest. The requirement that fund boards look at an advisory contract periodically was added to the statute to enforce the discipline—to use the board of directors in an oversight or a watchdog function to watch out for the interests of the shareholders.

Mr. DEAL. Let me ask you another question with regard to the directors. As I understand it, we are changing the process whereby you go through a nomination process rather than the board as a whole participating in that process? Explain that distinction and what the significance of that distinction is.

Mr. BARBASH. The provision that you are alluding to in the legislation would require the independent members of the board to be nominated and selected by the other independent directors. That is a type of arrangement that is used in many fund complexes today. It is in fact contemplated under one of our existing rules. The legislation supports the view that that would be something of a best practice that should be mandated on the industry generally.

Mr. DEAL. Is it mandated that only the independent directors can participate in the nomination process?

Mr. BARBASH. It is not currently mandated. Under the bill, they would have the responsibility for that activity.

Mr. DEAL. But the others would not participate in the process?

Mr. BARBASH. Well, the others would not under the provision in the bill.

Mr. DEAL. What is the reason for that?

Mr. BARBASH. Well, the underlying theory of the provision would be that the independent directors would be more independent if their selection and nomination were left to the other independent directors.

Mr. DEAL. OK, I want to talk just briefly about the fee, the unified fee products. As I understand it, we are talking about here not allowing the charge of other fees if they are in a process or just charging through a compensated broker. Would you explain the difference between the sales load charges and the other advisory fees that I understand are now disallowed; is that correct?

Mr. BARBASH. Well, the proposal in the legislation would allow a fund company to have a unified fee but would not contemplate the imposition of a sales charge. So this kind of fund would be able to pay a fee to its investment adviser for services rendered to the fund in selecting investments and monitoring those investments.

What would not be contemplated are sales charges, which would mean that an investor would not be able to pay a charge to a broker in the form of a commission in entering this kind of arrangement. The idea behind that limitation is that the proposal does not afford shareholders voting rights that they have in a typical mutual fund under the Investment Company Act. The theory of the proposal would be to provide investors with the opportunity to vote with their feet—that is, leave the fund. The imposition of a sales charge could be said to impair the ability of investors to vote with their feet by virtue of having paid a sales charge.

Mr. DEAL. Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Washington State, Mr. White.

Mr. WHITE. Thank you, Mr. Chairman, and welcome, Mr. Barbash. You're nice to come and share some thoughts with us today.

Let me ask you a little bit just in general, what is the Commission's sense for how the Investment Company Act is working in general? I mean, we all recognize there are some changes that need to be made and I understand the Commission recognizes that also.

Are you dealing with problems on a regular basis that you are seeing or is it your sense that this really isn't much of an issue at the present time?

Mr. BARBASH. I think as a general matter, the Commission has been happy and I think the industry has been happy with the operation of the Investment Company Act. The Investment Company Act has proved to be one of the best statutory, regulatory devices that has been developed over time by Congress. Some might argue that the reason for that was the process by which the Investment Company Act was created, a joint process between the Commission and the industry. The act reflects, perhaps, more industry, more outside information of professors, et cetera, than other provisions. It was perhaps an historical oddity that that has happened.

Mr. WHITE. You mean an historical oddity that we produced some good legislation is what you are saying?

Mr. BARBASH. I think one of the keys to the Investment Company Act, though, is that while it creates a number of flat prohibitions, it affords the SEC the ability to make administrative judgments and to provide the industry some flexibility in terms of dealing with those prohibitions. What this has allowed us to do is to keep up with the industry.

I would compare the Investment Company Act with the Public Utility Holding Company Act of 1935, an act over which I also have jurisdiction. That is a much more restrictive act with much less discretion given to the SEC and now Congress is at a stage where it is considering whether to repeal that act and in fact we have suggested that a conditional repeal may be an appropriate way to go. The Investment Company Act, though, has proved to be adaptable and that has been its strength.

Mr. WHITE. You would agree with me, though, I take it, that it is probably overdue for an update or at least it is time to update some of its provisions?

Mr. BARBASH. I think like any law that is 55 years old, it is in need of a reconsideration. Some of the provisions were time sensitive.

Mr. WHITE. Let me suggest one provision. What about the 100 person limit that applies to these companies now. Is that something that maybe we could modernize and expand a little bit or what is your thought on that?

Mr. BARBASH. There is nothing magical about 100. I think if you go back and you look at the legislative history, the 100 person limit was effectively drawn out of the air; there is nothing special about it in other words. So one could go back and look at it and ask whether that should be changed, whether there should be an increase.

Mr. WHITE. What is your sense? Should it be changed?

Mr. BARBASH. To the extent there is any legislative history on that particular provision, the notion is that the 100 person limit was set at that level so as to indicate investors would have control over the funds. In other words, it was generally designed to help investment clubs, small companies, small groups of people who could watch over the control of their funds. One hundred may be the right level for that kind of exemption.

Mr. WHITE. Does the Commission grant exemptions from that number now? I mean, do you process a lot of waivers for that?

Mr. BARBASH. As a general matter, we have not provided exemptions. There have been some interpretations indicating that if the 100 investor limit was breached due to extenuating circumstances, we would not take enforcement actions. But as a general matter, we have not granted exemptions.

The Commission has always had difficulty when Congress has imposed a numerical test, granting exemptions from those tests. Requests for such interpretations or exemptions need to be considered closely.

Mr. WHITE. If we picked another arbitrary number, say 200, would that make an appreciable qualitative difference on the act in your sense or 500 or——

Mr. BARBASH. It is very hard to assess what the number would be. If you were to ask what the effect would be on the industry relying on an expanded provision, I think it is fair to say that there would be more companies relying on the exemption. I think that would afford that part of the industry some greater flexibility.

As I said, there is some question about 100 and there may be a difference between 100 and 200 qualitatively with respect to control of the fund. We have looked to the notion of a sophisticated investor pool as another way of answering the question of whether the 100 investor limit is too inflexible and whether there is another way to provide flexibility without losing investor protection.

Mr. WHITE. Thank you and thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The Chair will recognize himself for a second round of questions.

Mr. Barbash, in your testimony you did not touch upon the Federal/state relationship but I want to give you an opportunity to do so because the witnesses following you do touch upon that particular subject and the Chair would like to enter for the record a speech that was given by Chairman Levitt to the North American Securities Administrators Association on October 23, 1995, and without objection that will become part of the record.

[The speech follows.]

REMARKS BY ARTHUR LEVITT, CHAIRMAN, U.S. SECURITIES & EXCHANGE COMMISSION, "THE SEC AND THE STATES: TOWARD A MORE PERFECT UNION" BEFORE THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION CONFERENCE, VANCOUVER, B.C., OCTOBER 23, 1995

Let me begin by congratulating incoming President Dee Harris and President-elect Mark Griffin. I also want to thank Phil Feigen for his outstanding leadership during a time of change and transition.

I'd like to talk to you today about some of those changes, particularly those set in motion by last November's election, and how we might best address them. I want to open up a dialogue that is candid, serious, and constructive. It may cause us both some discomfort, but I believe we've built up enough trust and good will between us to endure a little discomfort.

I recognize that these are sensitive subjects. But I come before you as a partner and a friend, in the belief that it's better to face tough issues together, than to face them apart.

All of us sense that this is a crucial moment for the securities industry and its regulators. If we didn't realize it last November, and if by chance we missed it during the debate over securities litigation reform, there's been no mistaking it since the introduction of the Capital Markets Bill by Congressman Fields.

The SEC and the states had been working in earnest for two years to address some of the problems in our dual system of regulation. The proposal for federal preemption came unannounced, but we've got to look beyond our immediate reaction and ensure that the important questions get addressed.

This Congress has been characterized by a call for fundamental change. Many of its members see a wide gulf between what is, and what should be.

Both we and Congress have a choice about how to conduct this debate: We can engage it forthrightly, and even enthusiastically, in the best American tradition. Or we can man the barricades, and fight each other tooth and nail.

Like you, I believe in the value of vigorous debate. Thomas Jefferson said we need a little rebellion from time to time; I now understand more clearly what he meant.

I've always felt that it's healthy to question your most basic assumptions, and the Republican ascendancy has forced all of us to do just that. For the same reason, I give credit to Jack Fields: some of the issues he has raised need to be aired—including, in an age of deeply diminished resources, the duplication of effort between state and federal regulators.

The debate over the respective roles of Washington and the States in securities regulation has been proceeding for three-quarters of a century. In 1920, Congressman Edward Dennison proposed a bill under which the federal government would have enforced state securities laws. Seventy-five years later, the Fields Bill proposes that the states enforce the federal securities laws. The pendulum has swung from one extreme to the other.

At the same time, the current debate has become too pointed, too passionate, and too polarized. Harsh words are used to cover up soft arguments. Code words like "pre-emption" and "states' rights" are lobbed like grenades, setting off alarms that drown out responsible dialogue.

If we do nothing else today, I hope we can help to change the tone of the debate from polarized extremes, to one in which reasonable people can disagree, but still reason together. We owe it to the citizens we are sworn to serve.

The truth is that the current system of securities regulation is not the system you and I and the Congress would create if we were starting from scratch. Although great strides have been made, it won't surprise you that many think our combined regulatory structure still looks more like the product of Rube Goldberg, than of Thomas Jefferson.

This is not a criticism of the states, which do an excellent job of protecting investors. And it's not a criticism of the SEC, which does its work well, too. It is a criticism of the way we come together, or fail to come together.

When both the SEC and the states have coordinated and cooperated, the system has worked. I like to think that's been true of my tenure as Chairman. I don't believe that any Commission has been more supportive of the states—and certainly no Commission has ever been better supported by the states.

Our efforts to work better together began soon after I came to the Commission. We created coordinating committees and joint meetings which, for the first time ever, gave NASAA a role in the SEC's decisionmaking process. Together, we've compiled an enviable record of achievements: Profile prospectuses. Joint sweeps of brokerage firms and investment advisers. Wrap fee disclosure. Joint training of examiners. Investor education initiatives. Enforcement matters like the Prudential case. And much, much more.

But by the same token, when the urge to cooperate has been lacking, the system has been, at best, dysfunctional—consider, for example, the experience of the Commission's 1992 Small Business Initiatives. A promising set of initiatives was made less successful because of a lack of coordination between us.

No one has worked harder in the cause of uniformity than NASAA—I recognize that, and applaud it. Uniformity is one of your stated goals, and I believe it offers us a starting point for a new chapter in the debate—a middle ground on which we can build a broader consensus.

Is there waste and duplication? Of course there is—and by definition, that means that at least part of the problem lies with the SEC and SROs.

In an era when all of our budgets are being cut, we need to cooperate more efficiently, divide responsibilities more clearly, and use our limited resources more strategically.

Is the SEC willing to take a hard look at itself as we re-evaluate our respective roles? You bet we are—and we will.

Are the states crucial for investor protection? Unequivocally. State regulators are the front line of defense, and you're often the first to identify potential problems, before too many investors are harmed.

We recognize and support your vital role. A few weeks ago, for example, the SEC introduced its own site on the part of the Internet known as the World Wide Web. One piece of information we made very sure to have up there was the title, address, and phone number of every single state regulator.

You do important work. There are areas in which your role should be expanded—examining investment advisers, for example.

Your programs need to be well-funded. Whether it is filing fees from mutual funds, corporate securities, or registration fees from broker-dealers, I believe that you should continue to receive the funds you currently receive. The local cop must be there walking the beat.

But at the same time, with a limited number of cops, it's important that we don't all walk the same beat.

I will defend your right to protect investors. But there is no defense for duplication; there is no defense for waste; there is no defense for needless burdens on legitimate businesses.

If we work at it together, we can come out of this with a better deal for American investors, businesses, and taxpayers.

Besides the limited resources we have for investor protection, there's another compelling reason to seek a better alignment of state and federal responsibilities: The world has remade itself several times over since 1933, and the nature of the securities business has changed. Communications technology is far more advanced because of computers; international travel and mobility are much easier; and investment instruments are more complex. Most importantly, today we are a global market—we are not 52 separate markets.

One state regulator recently wrote that "The states need to recognize that the industry does face a problem of 52 separate jurisdictions, and . . . there is a business cost to these regulations." I agree. To force American firms to cope with a regulatory jigsaw puzzle with each new offering or product, is to saddle them with a competitive disadvantage in the global marketplace.

That regulatory puzzle can also deter foreign firms from listing here, which in turn reduces the opportunities available to American investors. This is a competitive disadvantage for the nation.

The sovereign states of the European Union have agreed that, as of next January, an offering of securities approved by one of them, is approved by all of them. Surely we should be watching that experiment to see if it holds any lessons for us.

It's easy to show that the current system is far from perfect. The hard part is figuring out how to make it better. That's why I applaud NASAA's announcement, which you will hear more about shortly, of a blue-ribbon panel to study the relative roles of state and federal securities regulation. The panel includes some of the most distinguished people in the field. In light of the fact that a legislative solution is already being discussed, I am especially pleased that the panel is committed to a six-month time frame.

In the meantime, let me take this opportunity to raise some ideas about a possible middle ground in six key areas of activity—investment advisers; investment companies; registration of brokers; broker-dealer examination; registration of corporate securities; and enforcement authority. I ask you to keep in mind that these ideas constitute the beginning of a dialogue, not the end.

INVESTMENT ADVISERS

Let me start by addressing an area I believe strongly requires state regulation: investment advisers. Their number exceeds 21,000 today—an increase of more than 500 percent in the last 10 years. Most of them are smaller advisers, who are examined, on average, once every 44 years.

We clearly could use your help. There's no doubt in my mind that coverage would be better if the states assumed primary responsibility for examining the smaller advisers.

I call this "reverse pre-emption," because the federal government should step aside and defer to the states when it's clear that they can do a more effective job. After all, you're right on the scene, and able to see problems that may be lost when viewed from the distance of Washington.

Earlier this year, Senator Gramm proposed a similar division of responsibilities. I think that the states and the SEC ought to persuade Congressman Fields to en-

dorse Senator Gramm's proposal, with minor modifications, and add it to his own bill.

INVESTMENT COMPANIES

It's difficult to make a similar case for investment companies, which are comprehensively regulated at the federal level. In fact, a strong argument can be made that reducing their oversight by states will not compromise investor protection.

The fact that fund sales are national also makes a good case for national regulation. Some of the stories told about the current system sound like Kafka: What is a national investment company supposed to do when several states impose investment limitations that conflict with federal law—and conflict with one another? As I see it, investment companies would be exempt from state review, but would continue to file documents with the states and pay the same fees. The Commission would continue to seek input from NASAA in our rulemaking process with respect to investment companies. And of course, the states would still enforce sales practice violations.

It seems to me that the investment company and investment adviser proposals make a great deal of sense. Together, they constitute a good beginning on which to build a broader agreement. To acknowledge their merit is to show good faith and to build credibility early in the legislative process. I'd like to see the SEC and NASAA work together to do that.

REGISTRATION OF BROKERS

That brings me to broker registration. State regulators have a compelling interest in who is opening up shop in their area. The states should continue to license brokers doing business within their borders.

At the same time, brokers and firms have a compelling interest in a centralized and predictable registration system. NASAA has made significant efforts to coordinate state registration processes through the Central Registration Depository. But the system remains cumbersome. There's a need for greater uniformity of the criteria state regulators use to decide if a broker can do business in the states. The current system can too often seem arbitrary.

When a broker changes firms, for example, if there's been a complaint about him, his registration can sit on a state regulator's desk for weeks or months. That's not always efficient, and in many cases, it's not fair.

As things stand today, a broker can accumulate a number of complaints and trigger no regulatory review as long as he stays with one firm. Because it is legally easier to deny a license than to revoke one, the system focuses your attention on the point in time when a broker changes firms. Although I understand the reasons for this, investors would be better protected if our response were triggered by complaints, not by job changes. Technology can be part of the solution. The new CRD will begin to come on line next year, giving you a powerful new tool that will help you focus on complaints when they occur. There will be no reason to wait for a broker to transfer firms before you take action; and from the firms' and the brokers' perspective, the system will be more fair and more predictable. I applaud your diligent work in cooperating with the NASD and the securities industry to design a more rational and fair licensing system.

In addition, I understand that some of you have discussed the possibility of a "national license." That also sounds like an interesting idea, and I'd encourage you to pursue it.

One of the most difficult problems in our current system has to do with making unadjudicated complaints available to the public on the CRD. It pits a broker's right to due process against an investor's right to know her broker's background. Personally, I would be more inclined to make unadjudicated complaints public if we found a mechanism to take meritless or unpursued complaints off the system within a reasonable time, let's say 2 years. Investors need to know who they are dealing with—but at the same time, a complaint is not a conviction and should not stain a broker's record permanently. This strikes a balance between interests.

Again, I understand that this involves state record keeping laws and that some progress is being made. If we find ways to take complaints that are meaningless off the system, it can only make the overall system more meaningful.

EXAMINATION OF BROKER-DEALERS

You have an interest in how business is being conducted in your neighborhood. For that reason, the states should continue to examine broker-dealers who are operating within their borders. State regulators play an especially important role in ex-

amining the bucket shops and fringe elements that may well escape the SEC's notice.

I believe that states should continue to receive the same fees they receive currently. But I also believe that the states shouldn't impose supplemental requirements that exceed federal and SRO standards with respect to books and records and capital requirements. Maybe there's a flaw in our books and records law, or our capital requirements, that makes them less useful as a standard. If that's the case, I commit to work with you immediately to see if we can address your concerns in OUR rules.

Imagine that you're a legitimate firm trying to do business in the United States. What's your biggest nightmare? Fifty-two separate books and records laws! If that's not enough, add 52 separate capital requirements.

Lest anyone interpret this as an attack on the states, I remind them that the SEC is one of the 52. We need to work together to give securities firms the uniformity and predictability they need.

Let's be honest: Uniform rules are rarely adopted uniformly. Each party to the process tinkers around the edges, creating a regulatory maze for firms to find their way through. That serves no one well. True uniformity, on the other hand, breeds compliance.

We also need a more efficient use of federal, SRO and state examiners. There are too many horror stories out there like the one I heard the other day—a brokerage firm was subjected to 15 sets of securities examiners in the span of 24 months. You can almost envision it: One examiner comes in just as another one is leaving. He demands all the same information. Why does this happen? Simply because you and I are not coordinated. There's no excuse for that.

We need to be more sensitive to the disruption we cause the firms. I envision a new partnership where we coordinate better and share intelligence whenever we can. At the SEC, we recently created an Office of Compliance Inspections and Examinations to better coordinate our own examinations. And now we're working with the SROs to correlate our schedules systematically. I intend to convene a "Planning Summit" where the SEC, the SROs, and the states will come together to wrestle with these issues. We must find a way to examine firms effectively without tripping over ourselves. This Summit would not be a one-time meeting—we need to meet regularly to discuss hot areas, scheduling, firms, priorities, and other areas of critical interest.

REGISTRATION OF CORPORATE SECURITIES

We could also divide responsibilities better in registering corporate securities. Before I go further, let me remind you that our EDGAR database of corporate filings is now up on the Internet—it's a tool not only for investors, but for state regulators as well.

States should continue to receive copies of SEC filings and the current level of fees should be maintained. Congress should codify the existing exemptions from state regulation for those comparable to listed and Nasdaq/NMS securities.

Certain categories of offerings that have often been a source of disclosure and sales practice abuses, and are sold primarily to retail investors, should continue to be reviewed locally as well as by the Commission—offerings involving limited partnerships, blank check, blind pool, bad boy, and penny stocks.

We should consider expanding the exemption from federal registration for intrastate offerings. This is something that is particularly within your special province. We could make it easier for corporations to sell intrastate offerings in the state in which they're headquartered, subject to state registration.

For the remaining categories of offerings—such as Nasdaq small cap stocks—perhaps a better system would be to have the offering reviewed either by the federal regulator, or by a state regulator, but not both. The choice might be left up to the company. Whatever we finally decide to do, we need to find ways to facilitate small business capital formation, without sacrificing investor protection.

Along this line, I understand that eight Western states are experimenting with regional reviews of certain types of small corporate offerings. All eight states are actively involved in the discussion, with one of them taking the lead in the approval process. I think that's a promising idea, and I'd encourage you to expand the scope of this interesting pilot program.

ENFORCEMENT AUTHORITY

I'll close with a brief word about the area in which we've worked best together, and that is enforcement. We've succeeded in establishing a model that could serve us well in the registration and licensing area.

The Prudential global settlement exemplifies the power we can bring to bear by working together to protect individual investors. We both acted swiftly, putting our sovereign prerogatives aside in the name of reaching a better settlement for investors. I'm convinced that this global settlement will not only stand the test of time—it will inspire us as we redefine our relationship in the months ahead.

Enforcement is where the knowledge and skills of the local cop on the beat are especially irreplaceable.

Who knows the local prosecutors better than you? Who works with them day in and day out? Who has better sources on the ground? Who has relationships with local players?

This is not to say that we've always coordinated our enforcement actions perfectly. Could we do better? Definitely. But that's a problem that's solved through leadership, not legislation.

CONCLUSION

I've outlined some preliminary views today. I've tried to do so reasonably, but without pulling punches, either.

I don't expect you to agree with every point I've made. But I do hope you'll respond to them, and to the bill itself, as legitimate proposals, worthy of debate. I've also asked Jack Fields personally to be open to your concerns and to meet with you.

The alternatives to a reasoned discussion are unthinkable and unproductive—on the one hand, remaining silent in the hope that it will all go away; on the other hand, shooting sound bites at Congress across the pages of the daily newspapers. We need an honest debate, and we need it soon. There is no such thing as being too early to discuss ways to improve our system. But there is such a thing as being too late.

In 1933 and '34, Congress offered American investors unprecedented protections with the securities laws. Today, we have a real opportunity to make this aspect of the New Deal a better deal for all Americans. We may very well fail to achieve it; but we must not fail to try.

Mr. FIELDS. In his speech, the Chairman spoke, I think, with great sensitivity and really requested an engagement with different state regulators in examining this question and to quote from the speech, and I don't want to paraphrase all of it, but he says, in fact, a strong argument could be made that reducing their oversight, meaning mutual funds, by states will not compromise investor protection. He went on to say, the fact that fund sales are national also makes a good case for national regulation.

Some of the stories told about the current system sound like Kafka. Now, what is a national investment company supposed to do when several states impose investment limitations that conflict with Federal law and conflict with one another. In fact, the testimony that will be given by Mr. Fink in just a moment talks about the scheme of our national/state regulators and he identifies 18 different types of regulatory schemes.

But Chairman Levitt went on to say, as I see investment companies would be exempt from state review but would continue to file documents with the states and pay the same fees. The Commission would continue to seek input from NASAA in our rulemaking process with respect to investment companies and of course the states would still enforce sales practice violations.

Any comment?

Mr. BARBASH. Chairman Levitt did make that speech and I did read that speech.

I think he would contemplate testifying and presenting the Commission's formal views. The speech reflects the regulatory landscape at the present time. I am not sure that state regulators would disagree. It is just a question of coming up with a way to

deal with it and, as I said, the Chairman would expect to testify himself on that particular question.

Mr. FIELDS. And one last statement I will read in fairness to the Chairman. He said, I would like to see the SEC and NASAA work together to do that.

So again, I want to stress I thought the speech he gave was highly sensitive and realized how difficult an issue this can be but also it recognized the need for consideration of important change and the reason I asked the question was not to put you on the spot but there will be testimony elicited in a few moments on that particular subject.

Let me turn to something else. There will also be testimony given just in a few moments that the legislation as currently drafted includes a number of provisions that significantly increase recordkeeping and periodic reporting requirements as well as the SEC's access to investment company files. As you can imagine, those provisions are strongly disfavored by the industry as being excessively burdensome. In addition, the industry's concern that allowing the SEC access to sensitive internal documents such as internal auditing and compliance documents would compromise the effectiveness of internal auditing and compliance functions. And it is going to be argued that an alternative approach to providing the SEC with additional information when it is necessary such as in times of market crisis could be more effective.

I ask that question because a moment ago when you were asked by Mr. Stearns, it seemed that you were talking about your concern and the need for a systematic receipt of information and I am not sure that when you made that statement it was tied to a particular time but in other words, you know, a periodic time but you really needed a systematic receipt of information where there was market stress.

Mr. BARBASH. Clearly one of the issues that we have needed to address is getting information in times of market stress. We have often been asked about what we need to do to regulate funds in that situation, and to evaluate that question and to know how we should regulate or whether we should regulate depends on our having information. Our seeking greater authority with respect to recordkeeping and reporting is to get more information on the one hand to allow us to respond effectively as regulators in times of market stress. It is also designed to allow us to respond effectively in our inspections program.

In addition, with respect to the burdensome nature of the provisions, the provisions that are contemplated in the bill are authority provisions. They are not indications of how we are going to exercise that authority. If we had that authority we would develop rules and there would be an open rulemaking process through which we would hear concerns about the burdens and the costs. We would weigh those costs against investor protection and other considerations. So I don't believe that the provisions would show that we are not sensitive to the burdens on the industry. I think that we are and I think we have a history of being so.

Mr. FIELDS. Thank you very much. The Chair's time has expired. The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

I did not arrive in time to deliver my opening statement, Mr. Chairman, and I would appreciate it if my opening statement could be included in the record.

Mr. FIELDS. Without objection.

[The prepared statement of Hon. Edward J. Markey follows:]

PREPARED STATEMENT OF HON. EDWARD J. MARKEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Thank you, Chairman Fields.

Mr. Chairman, as the father of a young daughter, you know that today is a day of great importance for children around the country. It's a day when we break with the routines of daily life to encourage a bit of mischief-making; a day when we welcome unexpected surprises, and laugh about being startled or scared.

What our children don't know, Mr. Chairman, is that today is also very important for them for another reason.

Many of the children that knock on our doors tonight will be knocking on the doors of colleges and universities within a few short years. To get inside those doors, however, will cost more than it ever has before. So families, in many cases earlier than ever before, will have to struggle to set aside enough savings to help make sure that their kids will be able to realize the dream of a college education and the promise of American life. For a substantial majority of those families, the investment vehicle of choice—indeed, the only type of investment many are likely to consider seriously—is a mutual fund.

It has been evident for some time now that mutual funds are one of the great American success stories of the second half of the twentieth century. The trinity of professional management, diversified portfolios, and effective regulation have democratized our financial markets and energized the capital formation process in ways that could not have been imagined 55 years ago. Every single day, millions of families send checks off to their mutual funds, investing their faith and their trust, as well as their cash, with people they don't know and will never meet. This has resulted in a remarkable and unprecedented flow of capital for businesses of all sizes and types, and has, according to *The Economist*, served to finance virtually all of the country's job growth.

The mutual fund legislation you have proposed, Mr. Chairman—the Investment Company Act Amendments of 1995, which I am pleased to have cosponsored—recognizes that the legacy of overseeing the regulation of the fund industry is a profound responsibility.

Because your bill is the first significant legislation to affect the mutual fund industry and fund investors in a generation, the bill rightly targets what one witness called the "cobwebs" that have accumulated over the years. Thus the bill seeks to eliminate the need for funds to hold costly shareholder votes for ministerial functions like choosing the fund's auditors, and eliminates restrictions on advertising that have ceased to serve investor needs.

The bill also proposes a more workable and modern approach for sophisticated investors and private investment companies who choose to operate outside the scope of the statute. This provision will give these private investment companies opportunities for significant new growth, while reducing the regulatory uncertainties that have plagued them in the past.

And the bill encourages the spirit of innovation that has often been an important part of the relationship between the industry and regulators at the SEC. Some of our witnesses can no doubt remind us that not too many years ago, there was no such thing as a "no-load" fund, or a money market fund, or even a bond fund. Today we hear the views of the industry and the Commission about the wisdom and likely success of an effort to create a "unified fee" mutual fund.

Let me conclude, Mr. Chairman, by offering a final comment about what I think today is all about. Although the Jack-O-Lanterns and costumes make it easy to forget, Halloween started out as an event to celebrate the arrival of All Saint's Day. Investors who've looked at their statement so far this year may be prepared to nominate some of our witnesses for sainthood.

If that's even remotely true, it should be instructive. Our capital markets are all operating at historic highs. By virtually every statistical measure, the markets are vibrant and healthy. In light of that fact, I think that the nation's 80 million investors would prefer that the Congress avoid making mischief with the securities laws that have worked so well for so many years and are, in so many respects, the envy of the world. This is not an argument against examining the effectiveness of our laws and regulations, for I have long believed that even healthy patients need

checkups. But our exam need not be conducted under the extreme procedures and pressures of the emergency room. Unlike our children on Halloween, investors tend not to laugh when they are startled and scared.

The mutual fund legislation you have developed to modernize the Investment Company Act of 1940 could easily serve as a model of how to go about reviewing the other federal securities laws. Again, I commend you for the leadership you have demonstrated in preparing this legislation and holding this hearing, and I look forward to working with you as we move the bill promptly toward a markup.

Mr. MARKEY. Mr. Chairman, I want to commend you for the leadership which you are demonstrating on this issue because your bill is the first significant legislation to affect the fund industry and fund investors in a generation and the bill rightly targets what one witness called the cobwebs that have accumulated over the years.

What I think has become evident for some time now is that mutual funds are one of the great American success stories in the second half of the twentieth century, that the trinity of professional management and diversified portfolios and effective regulation have democratized our financial markets and energized the capital formation process in ways that could not have been imagined 55 years ago. Every single day, millions of families send checks off to their mutual funds, investing their faith and their trust as well as their cash with people they don't know and never will meet. This has been, as a result, a remarkable and unprecedented flow of capital for businesses of all sizes and types and, according to the economists, served to finance virtually all of our country's job growth.

Now, let me ask a few quick questions if I could about those cobwebs. The Investment Company Act, Mr. Barbash, of 1995, would give the Commission express authority to create a new investment company advertising prospectus. What benefits do you think this proposal would bring?

Mr. BARBASH. Right now, investment companies are constrained in their advertising. They are subject to a rule that says that the content of their advertising has to be no more than the substance of what is in their prospectus. The result has been that advertising providing information to investors is tied to what is in the prospectus. What companies do in order to deal with that requirement is load up their prospectus with a lot of information that may not be useful to investors in the way in which it is written so that they can take bits and pieces and use it in other types of disclosure documents.

The legislation would streamline the requirements and allow fund sponsors and funds to provide better information, we would argue.

Mr. MARKEY. And you believe it can be done consistent with protection of the investor as well?

Mr. BARBASH. Yes, because the sponsors and funds would still be prohibited from making misleading statements.

Mr. MARKEY. The next question, the Investment Company Act specifies the shareholder votes that funds must obtain to secure approval of certain matters. I understand that many funds spend considerable time and expense in seeking the requisite votes, particularly when a large number of proxies provide no voting instructions. The legislation seeks to address these difficulties by giving

shareholders who have provided voting instructions on specific matters the right to decide these matters.

Does that approach make sense?

Mr. BARBASH. The approach may make sense if we can conclude that shareholders in mutual funds don't care about the right to vote and we concluded that the system had no less integrity because some small number of shareholders were allowed to vote and carry a particular matter. We acknowledge the pain that some fund sponsors have to go through in order to get the vote. We continue to be concerned about whether shareholders would view this as a lessening of their protections.

Mr. MARKEY. But there is room here for modification, is there not?

Mr. BARBASH. I think that is true. With respect to this particular provision, we take to heart the idea that this legislation is a work in progress. We are not closed-minded to this particular provision.

Mr. MARKEY. We do want to work with you on that in order to make adjustments where it makes sense and I think we can do that. We have been working on a bipartisan basis to try to reconcile those differences.

Mr. Barbash, I have in my hand two magazine articles, both of which address very similar issues. One asks whether "the love affair between investors and mutual funds will make the financial system less stable." The other article asks whether in a falling market millions of panicking shareholders will redeem their shares sending the market into a nosedive.

The first article was written in the economist last week. The second article was written in Time magazine but it was written when my counsel here, Mr. Forde, was 18 months old.

Is there something comforting, Mr. Barbash, about the fact that 35 years apart, the same cautions and concerns have been expressed about an industry without them having come to pass?

Mr. BARBASH. That does illustrate that the same issues come full circle. It also would suggest that the industry has not suffered that particular fate although it is hard to rely too much on history. It is like drawing on past performance, it is really not predictive. So one can never get completely comfortable that history will indicate what will happen in the future. But the past result has been that fund shareholders have not left in droves. That is the history in 1987 during the market stress of that time. During 1994, fund shareholders did not pull out in droves.

I think in the final analysis, fund shareholders are not one block, they act differently depending on their individual situations.

Mr. MARKEY. By the way, congratulations. You gave the same answer that your predecessor 35 years ago gave at this committee table, a verbatim response to the very same question.

Mr. BARBASH. Although consistency is the hobgoblin——

Mr. MARKEY. So your point is that that even if you flipped a coin 35 times in a row and it came up heads every time, on the thirty-sixth time, there would still be a 50/50 chance that it would come up tails on that thirty-sixth chance which I guess is possible. But the reality is that the mutual fund industry has been the great success story in our country and it is largely as a result of the cooperative relationship that has existed between the industry and the

regulators over the years and to the extent to which we were working with the Chairman were able to update those laws and give the SEC the additional authority which it needs in order to be flexible in its dealings with these issues, I think the greater the likelihood is that they will continue to be the great success story in the American financial marketplace.

So I want to thank you for the work that you do and, you, Mr. Chairman, again, for the work that you are doing on this——

Mr. FIELDS. The question is, was Mr. Forde reading those articles at 18 months old.

[Laughter.]

Mr. FIELDS. The gentleman's time has expired.

The gentleman from New York, Mr. Frisa.

Mr. FRISA. Thank you, Mr. Chairman.

Mr. Barbash, I am very interested in what the SEC may have in mind in terms of electronic delivery of prospectuses and with regard to electronic advertising as separate and apart from the gentleman from Massachusetts with regard to print advertising, I think a related question is with regard to electronic advertising that it also could include Internet.

Mr. BARBASH. We recently, within the last 2 weeks I believe, put out a release articulating the Commission's views on electronic delivery of information including prospectuses and generally in that release took the position that electronic delivery was workable, and should be allowed consistent with the obligations of a company under the Federal securities laws. Fund companies, for example, which have been on the forefront in terms of using electronic means, can take comfort from this release and can seek to deliver documents electronically.

So we have tried to facilitate that type of delivery through that release.

Mr. FRISA. What does a company have to do, though, to do more than take comfort? I mean, to be able to actually effectuate delivery?

Mr. BARBASH. The release sets out certain guidelines for funds to follow. The guidelines are there and the funds can, as of this point, go forward with electronic delivery of documents. In fact, they had been using electronic delivery on a small scale before the release was published so there is no bar to doing it at this point; they can do it.

Mr. FRISA. And when you say "release," is that a press release?

Mr. BARBASH. No, it was an SEC release, an SEC formal policy statement. It was a statement of the Commission as opposed to a statement of the SEC staff, so it is an important statement in terms of SEC regulatory statements.

Mr. FRISA. And what about the related issue of electronic advertising?

Mr. BARBASH. Electronic advertising is also contemplated by the release. It can be undertaken consistent with the principles in the release.

Mr. FRISA. Could you enunciate a few of them for us?

Mr. BARBASH. In terms of the principles?

Mr. FRISA. Yes. I would just kind of like to get that on the record; I think that is important.

Mr. BARBASH. Essentially, there are delivery requirements under the Federal securities laws and funds and other issuers, so long as they meet their obligations under the securities laws, can use electronic means to provide documents.

There is generally a notice requirement and a consent requirement that is built into the use of those kinds of documents. In other words, you as an investor would be asked whether you wanted to receive your documents through electronic means, and you would need to provide consent to ensure that was, in fact, what you intended. From that point on, you could get certain documents through electronic means, which could be, for example, through a Web site or other types of electronic means.

The Commission tried in the release not to be tied to any particular computer system and that is the reason why we developed general principles.

Mr. FRISA. Good. Thank you.

Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Thank you, Mr. Chairman.

Under current law, we have the 100 person limit for private investment companies. Let me ask you a question.

Suppose you have an investment company that is subject to the 100 person limit. An investor who has a large family dies, bequeaths it to his five children and that puts them over the 100 person limit. Do you think there ought to be an exception for those kind of situations either in the inheritance or any other action where the fund does not have any control over the circumstances?

Mr. BARBASH. There have been some instances where the Commission staff has permitted the 100 person limit to be breached for a period of time in order for a private fund to come back under the 100 person limit. I think that we would be at least receptive to that notion. I am not sure there is a need for an exemption, though, to cover that situation. I am not sure how prevalent that type of situation is.

Mr. GILLMOR. What is your practice now? What do you do in that situation?

Mr. BARBASH. It would depend on whether the issue was raised with us. The 100 person limit is a self-executing exemption. It may well be possible that a fund in that situation could conclude, based on advice of counsel, that going over the limit on a temporary basis does not throw the fund out of compliance with the 100 person test.

I am not sure that we have ever been presented with that particular fact pattern so I don't know that we have a position on that.

Mr. GILLMOR. Just from an equity point of view, do you think that makes sense?

Mr. BARBASH. I think there are arguments that can be made about that sort of situation because the crossing of that threshold could be somewhat draconian from the standpoint of a company that was below 100 investors and then all of a sudden found itself subject to various regulations.

I think that notion underlies the Commission's staff, at least in the past, in some analogous situations determining that there is some room for going over the limit.

Mr. GILLMOR. So you probably would not have an objection if we made a fix of that nature?

Mr. BARBASH. I think a fix of that nature would probably be consistent with what our determination would be on a policy level. But I am not sure, as I said before, that you need to make a legislative fix on that. I am not sure that that is that significant a problem.

Mr. GILLMOR. Could you give me a brief description of the difference of the liability that the act now imposes on an investment company directors for evaluating fees and also the new standard that is proposed and in light of those two standards, what is your view about how having a dual standard might affect litigation?

Mr. BARBASH. The existing standard is in Section 36(b) of the Investment Company Act and the standard essentially is that the board and the adviser are held to a fiduciary standard. In other words, the setting of the fee has to be consistent with what a fiduciary would do. You are subject to the standard of care imposed on a fiduciary.

The courts have suggested that a fee needs to be within a range that can be negotiated by parties that are not related to each other. The standard that you refer to would be the standard of unconscionability in fees that would be set out in the UFIC provision. The rationale for it is that the UFIC is a different type of investment company; it has a straightforward, simple fee so that the standard could arguably be somewhat different, somewhat lower than the standard applied to investment company directors and advisers generally.

I don't think it is inconsistent to have different kinds of funds with different types of attributes subject to different liability standards. I don't think that would have a significant bearing on litigation because the standard would govern the type of fund that you had.

Mr. GILLMOR. Let me get into the area of independent—oh, I see my time has expired. So we will leave the independent directors go, Mr. Chairman.

Mr. FIELDS. If the gentleman would like a few more minutes, we are in the second round of questions. The gentleman did not get his first round, if he would like to proceed.

Mr. GILLMOR. Let me just ask this one on independent directors. I think there is a legitimate basis for providing that they be nominated by the fund's other independent directors in order to preserve that independence but, given the amount of research and other consideration that is involved in the search for qualified people, would you agree that it would make sense to let the entire board participate in the selection of the director as opposed to the nomination?

Mr. BARBASH. I think that is an issue where we would be receptive to hearing the arguments. Again, Chairman Fields has referred to this as a work in progress and I think that is a particular provision with respect to which we would be interested in input.

Mr. GILLMOR. Thank you.

Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

Does the gentleman from Washington State have additional question?

Mr. WHITE. No further questions, Mr. Chairman.

Mr. FIELDS. Mr. Barbash, thank you very much for coming today and we will see you again at 2:30.

Mr. BARBASH. I was going to quote from the horror flick, "I'll be back."

Mr. FIELDS. Now we have before us Mr. Matthew Fink, President of the Investment Company Institute; Mr. Don Powell, Chief Executive Officer of Van Kampen American Capital, Inc.; Mr. Paul Haaga, Senior Vice President, Capital Research and Management Company; Mr. James Riepe, Managing Director, T. Rowe Price Associates; and Marianne Smythe, partner, Wilmer, Cutler and Pickering.

Mr. Fink, when you are ready, you may proceed.

Your microphone is not on.

What we will do is we will recognize you for 5 minutes and we will be glad to put your statement in its entirety in the record.

STATEMENT OF MATTHEW FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE; JAMES S. RIEPE, MANAGING DIRECTOR, T. ROWE PRICE ASSOCIATES, INC.; DON G. POWELL, PRESIDENT AND CEO, VAN KAMPEN AMERICAN CAPITAL, INC.; MARIANNE SMYTHE, ESQ., WILMER, CUTLER AND PICKERING; AND PAUL G. HAAGA, SENIOR VICE PRESIDENT AND DIRECTOR, CAPITAL RESEARCH AND MANAGEMENT

Mr. FINK. Thank you, Mr. Chairman.

I would like to commend you and Mr. Markey for introducing this legislation to modernize the Investment Company Act. As was discussed with Mr. Barbash, Congress has not legislated in this area for 25 years and our industry has continued to grow and to use new technologies so it is an appropriate time to look at modernizing mutual fund regulation.

The overriding interest, I think, in modernizing regulation still must be the interest that drove the Investment Company Act of 55 years ago and that is the interests of shareholders, the protection of investors. And the bill you have introduced does that in a number of areas, in communications, in cost-effective regulation and corporate governance and in innovation generally.

But I would like to emphasize two different points dealing with investor protection. First, experience tells us that unregulated investment pools can pose very significant dangers for investors and if we just looked at the newspapers and television this past year, the Orange County Municipal Investment Fund, the New Era scandal and the Askin hedge fund give us recent examples.

The Investment Company Act has been very effective in protecting investors in pool funds and I would say there ought to be a very strong presumption against the Congress granting exemptions and if they are granted, they should be given by Congress, narrowly tailored and with very adequate safeguards.

Second, I think it is long overdue for Congress to come up with a sensible reallocation of regulatory responsibilities between the SEC and the states in the area of mutual fund regulation. Today, virtually every mutual fund in the country sells its shares in all 50 states and, as befits a national industry, we are very effectively regulated at the Federal level, notably by the Investment Company

Act. Every mutual fund, no matter where it does business or where its shareholders live, is governed by one set of rules, one set of standards set by the SEC and, in the case of advertising, the NASD. But in addition, today mutual funds must comply with the separate laws in each of the states where they offer their shares.

Regulations differ significantly from state to state. I think, Mr. Chairman, as you said in discussion with Mr. Barbash, we have identified 18 different schemes of state regulation and these differences create a very bewildering patchwork quilt of different regulation, inconsistent regulation, as shown in the map that is attached to my written testimony.

Some states, 18 states, give some form of exemption to most mutual funds. Many other states, however, frequently comment of mutual fund prospectuses that have cleared the SEC. A number of states not only regulate prospectuses but limit what a fund can invest in and that limit is different than the Federal limits.

Under this system, one states idiosyncratic or weird requirement becomes a national standard. For example, if one estate imposes an idiosyncratic investment restriction, says a fund can't invest in warrants or in convertible securities, the fund, in effect, cannot invest in them even though it is permitted by the SEC and 49 other states.

This crazy quilt hurts investors and that is the real point. It helps produce prospectuses that are hard to read, complex and not useful to investors. It undermines the SEC's attempts to improve prospectus disclosure.

In the case of innovations that are permitted by Federal law like master feeder funds, it destroys them, one state can block it. It makes all the mutual funds in the country, including the three at this table, spend a lot of time and money on compliance burdens that don't help anybody and it takes away the states from doing what they ought to be doing, being the cop on the beat and doing enforcement and education.

Years have been spent, I have spent a couple of decades myself, trying to remedy this problem state by state or through NASAA and it just doesn't work. It has become clear, as Chairman Levitt said last week, that only the Congress can devise a national solution because this is a national problem. And specifically, I would simply endorse the same scheme that Chairman Levitt outlined last week, that mutual fund prospectuses and advertisements ought to be cleared exclusively at the Federal level. Investment limits ought to be set exclusively at the Federal level. The states should retain their role in enforcement and should get fees and, if needed, have funds file notice filings so each state knows what funds are being offered in this state.

This system is found currently in the law of about a dozen states. It is in the Uniform Securities Act, it was endorsed by Chairman Levitt and almost everyone agrees that this is the model that we need.

So in closing—I am sorry to run over my 5 minutes—I would like to sincerely commend the subcommittee for considering legislation that would both modernize the Investment Company Act and indeed in other legislation the securities laws in general. A lot of issues you have may require more study than others but no issue

has been more studied to death and more documented than the problems that result from dual Federal/state regulation of mutual funds.

The need for congressional action, as I said and Chairman Levitt said earlier, is widely recognized as is the type of solution. We therefore would respectfully ask the committee that as you consider all of these issues in these two bills you have regarding securities legislation and mutual fund regulation in particular, that you keep open the option of addressing the mutual fund state problem in the current legislation H.R. 1495. I promise you we will do all we can to get this issue resolved because on behalf of our shareholders, the state problem is the industry's No. 1 priority.

The subcommittee has provided a tremendous opportunity to enact legislation as a number of other people said this morning to modernize this 55-year-old act which has worked so well, to make it more effective as a business matter and to better protect investors.

Thank you.

[The prepared statement of Matthew P. Fink follows:]

Prepared Statement of Matthew P. Fink, President, Investment Company Institute

I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 5,664 open-end investment companies (mutual funds), 449 closed-end investment companies and 11 sponsors of unit investment trusts. The Institute's mutual fund members have assets of over $2.5 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders. These shareholders reside in all 50 states and the District of Columbia.

Today, I will discuss the Institute's views on how to modernize mutual fund regulation so that it continues to provide effective investor protection while also responding to developments in the markets and changing investor needs. It has been over 20 years since Congress considered major mutual fund legislation. As the oversight hearings last Congress under Congressman Markey demonstrated, this is a testament to the continuing effectiveness of the Investment Company Act of 1940 as a governing statute. As is well known, during this time, the industry has experienced strong and steady growth. Today, nearly one in every three American households owns mutual funds.[1] In addition, computer, telecommunications and other technological advances are forging a truly global marketplace and revolutionizing the way mutual funds do business with their shareholders. As the 21st century approaches, it is timely and appropriate for Congress to examine whether changes to the regulatory structure for mutual funds are needed to meet the challenges ahead. The Institute commends Chairman Fields and Congressman Markey for their bipartisan initiative, as embodied in H.R. 1495, which aptly recognizes the importance of such an examination.

In my remarks today, I will briefly describe the growth of the mutual fund industry and its importance to our nation's economy. I will outline the Institute's vision of the goals of modernizing mutual fund regulation. I will recommend that Congress take a very cautious approach to the exclusion of any securities pools from the investor protections of the Investment Company Act. Finally, and perhaps most importantly, I will urge that Congress establish, in the interest of investors, a more sensible allocation of responsibilities in mutual fund regulation between the SEC and the states.

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[1] An estimated 30.2 million U.S. households owned mutual funds in 1994. This estimate comprised households that owned money market, stock, and bond and income mutual funds, including those invested in 401(k), IRA and Keogh accounts. *Mutual Fund Fact Book,* Investment Company Institute (1995), p. 80.

II. THE GROWTH AND ROLE OF MUTUAL FUNDS

A. The Growth of Mutual Funds

Since passage of the Investment Company Act in 1940, the mutual fund industry has grown from 68 funds with assets of $448 million to over 5,500 funds at the end of 1994 with assets of $2.2 trillion.[2] As indicated in the chart below, contrary to reports that mutual funds suddenly "boomed" in the 1990's, fund assets grew at an annual rate of 23 percent throughout the 1980s, while growth thus far in the 1990s has been at a 19 percent annual rate.

Many factors have contributed to the growth of the mutual fund industry over the years. These include the capital appreciation of portfolio securities owned by funds; additional purchases of fund shares by existing shareholders; new fund products and services designed to meet changing investor needs; the growth of the retirement plan market; increased investment in mutual funds by institutional investors; a broadening of the channels of distribution through which mutual funds are sold; and a shift by individuals and institutions from direct investment in securities to investment through mutual funds. Some of these factors are reflected in the chart below.

In our view, however, the most important factor contributing to the growth of the industry is the stringent regulation imposed upon mutual funds by the Investment Company Act. This regulation has led to unprecedented investor confidence in mutual funds and to an environment characterized by strong industry compliance systems, full disclosure to investors and swift SEC enforcement.

B. The Role of Mutual Funds in the Capital Markets

Mutual funds are major financial intermediaries—bridges linking American investors with securities issuers. As such, they contribute to the financial well-being of millions of mutual fund shareholders, and help to fuel our nation's overall economic growth. Mutual funds play an important and highly positive role in the U.S. securities markets.

Mutual funds are an important source of capital for U.S. business. They have been the largest institutional buyer of corporate equities over the past five years. In addition, the growing popularity of aggressive growth and growth funds has stimulated the issuance of many new equity offerings by making it easier and less costly for new companies to issue stock.

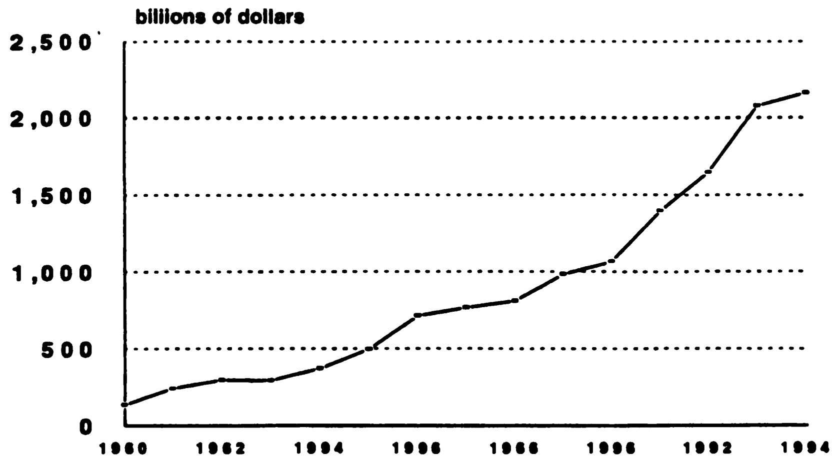
Further, the development and growth of tax-free money market and municipal bond funds have contributed significantly to the municipal securities market, helping to supply money to build schools, highways, bridges and other elements of the U.S. infrastructure. Over the past five years, mutual funds have made net purchases of nearly $170 billion in municipal securities, representing about three-fourths of net issuances of new municipal securities. Finally, mortgage-backed securities funds have expanded the market for securitized mortgage loans, thereby increasing the availability of residential mortgage financing for homeowners and lowering the cost of owning a home for millions of Americans.

III. THE GOALS OF MODERNIZING MUTUAL FUND REGULATION

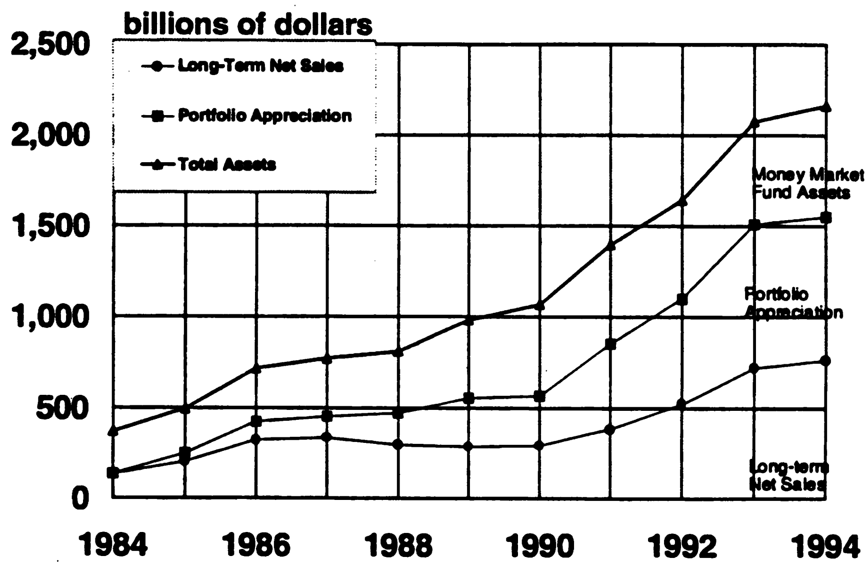
The growth of the mutual fund industry and its increasingly important role in our capital markets suggest that there is a strong national interest in making certain that the regulatory scheme remains as effective in the future as it has been in the past. While the existing federal regulatory framework is fundamentally sound, we believe that it should be modernized in certain respects in light of developments in the markets and changes in investors needs. In considering what the goals of modernizing regulation of mutual funds should be, the Institute submits that the primary objective must be to serve the best interests of investors. To this end, legislation seeking to modernize mutual fund regulation should: (1) facilitate communications between mutual funds and investors; (2) promote cost-effective regulation of mutual funds; (3) further enhance the highly effective system of corporate governance of mutual funds; and (4) permit innovation in mutual fund products and services. Each of these is discussed briefly below.

[2] *Mutual Fund Fact Book*, Investment Company Institute (1995), pp. 24-31.

Mutual Fund Assets, 1980 - 1994



Components of Mutual Fund Asset Growth



Source: Investment Company Institute.

A. Facilitating Communications with Investors

As H.R. 1495 recognizes, one of the most important ways in which mutual funds serve their investors is through various types and means of communications. These communications include the mutual fund prospectus, which, under the federal securities laws, is the key disclosure document that must be provided to all investors. They also include the reports that mutual funds are required to send to their shareholders on at least a semi-annual basis, as well as proxy materials on matters for shareholder voting. Finally, mutual funds also typically provide investors with a wide variety of other materials, including educational materials that cover such topics as saving for retirement or college education, the state of the securities markets and how mutual funds are operated and regulated. Funds often include information of this kind in newsletters, prospectus "wrappers," advertising and sales literature, as well as in their prospectuses and shareholder reports. Funds also are increasingly using the Internet, computer on-line services and other technologies as means of communicating with investors.

The quality of communications with investors is a matter of critical importance to the mutual fund industry—effective communication helps investors make informed investment decisions and ultimately helps maintain investor confidence. Well-informed investors understand the importance, and therefore reap the benefits, of investing for the long term. In this regard, there has been growing recognition on the part of both the industry and the SEC that, to be effective, such communications must be not only complete, but also clear and understandable.

The "advertising prospectus" concept proposed in H.R. 1495 is an important step toward facilitating and improving communications with investors, and the Institute strongly supports it. SEC Chairman Levitt's "profile prospectus" initiative also represents a significant improvement and innovation in effective communication with investors. Its use, as well as other efforts to facilitate and enhance communications with mutual fund investors, should be encouraged through legislation

B. Promoting Cost-Effective Regulation

To promote cost-effective regulation, legislative changes should reduce undue costs and burdens on mutual funds wherever this is possible without diminishing investor protection. In an era of more limited government resources, it is especially important to consider new, more effective means of accomplishing regulatory missions. Modern day regulators must be able to "think smart," taking into full account the relative costs and benefits of their regulations and strongly promoting industry self-compliance efforts. We are pleased that the stated purposes of H.R. 1495—"to promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation"—are fully consistent with these premises.

In order to achieve these goals, however, changes need to be made to rules adopted by the SEC under the Investment Company Act, as well as to the governing statute. Many of these rules have not been amended in many years, despite significant changes in the industry and the marketplace. The Institute recently filed a comprehensive package of regulatory proposals with the SEC, which, if adopted, would significantly help to eliminate costs and burdens on mutual funds while fully maintaining investor protection.[3] H.R. 1495 also contains important provisions that, if modified in certain respects, would reduce unnecessary costs and burdens on mutual funds while enhancing investor protection. These include, for example, the proposed elimination of certain outdated and unnecessary shareholder voting requirements (Sections 2(b) and (c) of the bill), the proposed revised definition of a majority vote (Section 2(g)) and the proposed "advertising prospectus" (Section 3). We are concerned, however, that other provisions of the bill, such as those concerning books, records and inspections (Section 4) and reports to the SEC and to shareholders (Section 5), could result in additional, unwarranted costs and burdens for mutual funds if adopted as proposed.

Like the Subcommittee, we are mindful that the current regulatory framework for our industry has proven notably successful and resilient, and changes should not be made at the expense of key investor protections. Thus, for example, Congress should proceed cautiously with any proposed exception of certain pooled securities vehicles from all provisions of the Investment Company Act, such as the "private investment

[3] The Institute's recommendations would codify various SEC staff interpretive positions, clarify certain regulatory issues, eliminate regulatory burdens imposed on activities that do not raise the concerns the Investment Company Act is intended to address, and modernize certain requirements to reflect current market conditions and contemporary industry practices. A copy of the Institute's submission is attached as Appendix 2 to this testimony.

companies" proposed in H.R. 1495. I will address this topic in greater detail later in my testimony.

C. Enhancing the Corporate Governance System

One of the most important features of the Investment Company Act is a corporate governance structure that was well ahead of its time. The Act requires every mutual fund to have a board of directors or trustees, at least 40 percent of the members of which must be independent of the fund's adviser. In addition, the Act imposes a series of specific duties and obligations on fund directors, over and above their duties under state corporate law.[4] The independent directors, in particular, are charged with policing the potential conflicts of interest that occur in the investment company structure. Thus, the directors serve a critically important role in overseeing fund operations and safeguarding the interests of fund shareholders.[5] In addition, the Investment Company Act provides protections to investors in the form of shareholder voting rights.

The system of corporate governance provided in the Investment Company Act has worked well and continues to protect and advance the interests of fund shareholders. Nevertheless, we believe that certain modifications, including the changes to various shareholder voting provisions proposed in H.R. 1495, could further enhance the effectiveness of the existing governance structure. In particular, we strongly support: (1) the proposed revision of the definition of a majority vote in the Investment Company Act; (2) the proposal to require a shareholder vote in connection with a proposed change in a fund's fundamental investment objective; and (3) the proposals to eliminate certain outdated shareholder voting requirements that do not relate to investor protection concerns (i.e., the ratification of fund auditors and the initial approval of a fund's investment advisory contract).

D. Permitting Innovation in Products and Services

Mutual funds have been leaders in responding to changing investor needs over the past several decades by introducing new products and services. For example, taxable money market funds were developed in 1972; long-term tax-exempt funds were first offered in 1976; tax-exempt money market funds were introduced in 1979; and during the 1980s, international funds, precious metal funds, Ginnie Mae and government income funds were developed. In addition, in recent years the industry has developed several new structures for mutual funds—including funds with multiple classes of shares and so-called master-feeder funds—that are designed to achieve economies in fund management and facilitate distribution. Among the many new services funds have introduced for their shareholders are toll-free (800) telephone numbers, 24-hour telephone access, consolidated account statements, shareholder newsletters, shareholder cost basis information, automatic withdrawals and reinvestment of fund dividends and investor information provided through the Internet and on-line computer services.

For the most part, such innovations can be accommodated under the present regulatory framework. The SEC has broad authority to adopt rules and to issue individual orders that permit the industry to respond in a timely manner to market changes and investor preferences. Nevertheless, as contemplated by H.R. 1495, certain amendments to the Investment Company Act could further facilitate this process.

The Institute strongly supports Section 9 of the bill (concerning "funds of funds") because it would give investors access to a broader array of investment products, while still maintaining important investor protections. We are encouraged by the SEC's recent grant of expanded exemptive relief to certain mutual fund firms currently operating "funds of funds." To make this increased flexibility available throughout the industry, without the need for funds to obtain exemptive orders, we urge that legislation along the lines of Section 9 of H.R. 1495 be adopted.

The Institute also supports the concept of a "unified fee investment company," as an optional new type of mutual fund. If properly structured, the "UFIC" could pro-

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[4] The specific responsibilities of the directors include, among others, considering fund contractual arrangements with the fund's investment adviser and other outside service providers, valuing securities for which market prices are not readily available, establishing policies for evaluating the liquidity of portfolio instruments, selecting fund auditors, overseeing fund compliance with applicable regulatory requirements, and adopting procedures to govern transactions with affiliated parties.

[5] In recognition of the increasingly complex and challenging responsibilities placed on mutual fund directors, the Institute offers a variety of educational programs and services for the director community. In addition to an annual conference as well as special workshops for fund directors, the Institute has developed an *Introductory Guide for Investment Company Directors*, and regularly publishes a newsletter for fund directors, *Board Bulletin*.

vide investors an attractive alternative investment vehicle, which would feature a prominently disclosed single fee that is readily understandable and easy to compare. Nevertheless, we believe that several changes to the provision in the current bill are needed if it is to achieve its intended purpose.

IV. PRIVATE INVESTMENT COMPANIES

The Institute generally supports the proposed exemption for "private investment companies" in Section 8 of H.R. 1495. This provision would exempt from regulation under the Investment Company Act an investment company that is owned exclusively by institutional investors and wealthy individuals meeting certain thresholds, on the theory that such persons can fend for themselves and do not necessarily need all of the protections provided under the Act.[6] In concept, this provision is consistent with the goal of cost-effective regulation, because it contemplates that the SEC should direct its regulatory efforts and resources toward those investors who most need the protections of the securities laws.

Nevertheless, the proposed exemption implicates important public policy concerns. In the past, Congress has been reluctant—rightly, we believe—to exempt pooled investment vehicles from the Investment Company Act unless sufficient protections have been established. When it has provided exemptions, Congress has done so cautiously and deliberately, appreciating the perils to the public investor and the American capital markets that can arise when pooled vehicles are relieved from the protections of the Investment Company Act.[7] The mass marketing and sale of unregulated pooled vehicles can pose significant dangers to the investing public and the American capital markets.[8] The abuses that led to enactment of the Investment Company Act and the problems that have since arisen from the marketing of unregulated pools should discourage the adoption of any but a narrow and very carefully tailored exemption from the Act. Indeed, it should be noted that the losses incurred by investors recently in exempt pools have prompted governmental authorities to consider or require applying the principles of the Investment Company Act to these vehicles.[9]

The proposed exemption from the Act—based upon the presumed financial sophistication or acumen of the investors—is unprecedented. Because the concept is so untested and the potential risks attendant to such an exemption are so significant, Congress itself—not the SEC—should prescribe the terms on which the exemption is available. This is the approach taken by Section 8 of H.R. 1495, and we believe it is the appropriate one. In addition, Congress should be wary of efforts to delegate to regulators the authority to weaken the standards under the exemption. In this regard, the Institute notes that a bill recently was introduced in this Subcommittee that would create a new exception to the Investment Company Act of 1940 for collective investment funds that are maintained by charitable organizations.[10] We un-

[6] Specifically, Section 8 would provide an exemption for "private investment companies," the outstanding securities of which are owned solely by "qualified purchasers." A "qualified purchaser" is defined generally to mean (1) a natural person who owns at least $10 million in securities, or (2) any other person, acting for its own account or the account of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis at least $100 million in securities.

[7] For example, Congress' willingness to exempt bank common trust funds under Section 3(c)(3) of the Investment Company Act was largely due to the fact that, since 1937, federal banking regulators have authorized banks to operate common trust funds solely as aids to the administration of *bona fide* trust accounts already managed by the bank. Because these funds are intended to be administrative devices rather than vehicles for general investment by the public, bank regulators have prohibited banks from advertising their common trust funds and from charging a fee to the common trust fund in addition to fees already assessed against the beneficiaries.

[8] As the recent Askin hedge fund collapse, New Era scandal and Orange County municipal investment pool bankruptcy demonstrate, many so-called "sophisticated investors" are quite susceptible to dangers resulting from investing in unregulated pooled vehicles. *See In the Matter of Askin Capital Management, L.P. and David J. Askin*, Investment Advisers Release No. 1492 (May 23,1995); Lewis, "Separating Rich People from Their Money," *N.Y. Times Magazine* (June 18, 1995); "Orange County, Mired In Investment Mess, Files for Bankruptcy," *Wall St. J.* (Dec. 7,1995).

[9] For example, the California Treasurer reportedly expressed strong support for requiring that local governmental pools mark their portfolio securities to market, reasoning, "By marking to market, I think those in the Orange County pool would have known much sooner... that they were in deep trouble." *California Treasurer Urges Regular Pool Fund Reporting to Flag Portfolio Risk*, The Bond Buyer (Jan. 17, 1995) (comments of Matt Fong, Treasurer). Mutual funds, of course, are generally required to mark their portfolios to market on a daily basis.

[10] The "Philanthropy Protection Act of 1995" (H.R. 2519).

derstand that that bill also correctly contemplates a narrowly-tailored exemption that does not give the SEC discretion to expand its scope.

In establishing the standards of a wholesale exemption from the Investment Company Act, Congress should seek to ensure that *only* those investors who truly are capable of fending for themselves will be eligible to purchase securities issued by these unregulated pools. As noted above, Section 8 of H.R. 1495 establishes $100 million and $10 million in securities holdings as the statutory thresholds for institutions and individuals, respectively. These thresholds, in our judgment, provide the necessary assurance that investors in such private investment companies have the requisite sophistication to be "qualified purchasers." We recommend that these standards be maintained.

In prescribing the terms on which the exemption is available, however, Congress also should seek to guard against situations where unsophisticated investors might be drawn inadvertently into an exempt pooled vehicle and subjected to the risk of loss that only qualified purchasers are in a position to bear. This might occur, for example, if financial institutions or fiduciaries were permitted to aggregate the individual accounts of small investors and thereby to satisfy the "qualified purchaser" threshold. In our view, this result would be completely inconsistent with the purposes of the exemption. We therefore would urge that Section 8 be amended to clarify that an offering to institutional investors who are "qualified purchasers" as a result of having aggregated the interests of non-qualified purchasers would not be permitted.

In addition, because unsophisticated or unqualified individuals could be inadvertently drawn into an exempt pooled vehicle if it were made available to the public through a public offering, Section 8 of H.R. 1495 should require that "private investment companies" be sold only in nonpublic offerings. In this way, Congress could better ensure that sponsors will control the offering and adequately determine that all potential investors qualify under the exemption.[11] Such a limitation further might clarify to the public and securities regulators the differences between these exempt pools and publicly-offered, fully regulated investment companies.

V. RATIONALIZATION OF FEDERAL-STATE REGULATION OF MUTUAL FUNDS

One particular aspect of the existing mutual fund regulatory scheme—the current dual system of federal and state regulation—stands out as a formidable obstacle to achieving many of the goals of modernizing mutual fund regulation. This duplicative, conflicting and inefficient system is harmful to investors, thwarts efforts to improve communications with investors, impedes innovation by mutual funds permitted by federal law and is the antithesis of cost-effective regulation. Progress in modernizing mutual fund regulation requires rationalizing this dual regulatory system. To this end, the Institute supports the adoption of legislation to redefine the roles of federal and state governments in the regulation of mutual funds. Such an initiative is important and long overdue.

A. Federal Regulation

The Institute has always supported strong federal regulation of mutual funds and a well-funded SEC. History has shown that effective regulation is essential to keeping public confidence in mutual funds. The current system of overlapping federal and state regulation, however, does not help, but rather hurts fund investors.

Today, virtually every mutual fund sells its shares to investors in every state. The extensive coverage of mutual funds by the national media, the use of new technologies to communicate with shareholders, the mobility of American investors, and the national distribution networks through which funds are offered are but some of the factors that make the mutual fund marketplace quintessentially national in character. As befits a national industry, mutual funds are extensively regulated at the federal level by four separate securities laws, notably the Investment Company Act, which imposes detailed substantive requirements on the structure and operations of mutual funds, as well as continuing disclosure and reporting requirements.

Among the specific requirements to which mutual funds are subject under federal law are those governing what a fund may invest in and those relating to the contents of fund prospectuses and advertising. For example, the Investment Company Act imposes limitations on certain types of fund investments, such as illiquid securities, and investments that money market funds can make. SEC Form N-1A dictates the type of information that must be included in a fund's prospectus. Form N-1A also prescribes the order in which certain items must be presented and specifies

[11] We note that today, hedge funds successfully issue their interests in private offerings exempt under Section 3(c)(1) of the Investment Company Act.

which items must be set forth on the cover page of the prospectus. The instructions to the form emphasize the need to ensure that information in the prospectus "is set forth in a clear, concise and understandable manner." [12] Moreover, all mutual fund prospectuses are reviewed initially by the SEC staff, as are material amendments. Finally, mutual fund advertising is subject to detailed requirements under various SEC rules. Most mutual funds also are required to file their advertisements with the NASD, which reviews them for compliance both with SEC rules and with the NASD's Rules of Fair Practice.[13]

It is important to note that under federal law, *every* mutual fund—no matter where it does business or where its shareholders live—is subject to the *same* strict and uniform scheme of regulation by the SEC and NASD. This uniform system of regulation is graphically illustrated in Appendix 1 to my testimony.

B. State Regulation

Despite this comprehensive scheme of uniform federal regulation, under the current system, a mutual fund also must comply with regulation in every state where it sells shares. These regulations differ significantly from state to state, year to year, and even fund to fund. The Institute has identified 18 different approaches currently taken by states to mutual fund regulation. These differences make a bewildering patchwork quilt of inconsistent regulation. Eighteen states, for example, grant some form of exemption to most or all mutual funds. Many of the other states frequently comment on mutual fund prospectuses. Of those states, some also impose substantive limits on the investments a fund can make. Still other states require funds to register, but do not review their prospectuses. A graphic illustration of this "crazy quilt" of state mutual fund regulation also is included in Appendix 1 to my testimony.

Under this system, the idiosyncratic requirement of a single state often affects investors in all 50 states. For example, because a fund's portfolio must be managed the same way for all fund shareholders, a portfolio restriction imposed by one state dictates how the fund's portfolio will be managed for investors in *all* states. Similarly, because mutual funds use a single prospectus nationwide, a single state's unique disclosure requirements can affect the disclosure received by *all* investors.

C. Resulting Harm to Investors

The "crazy-quilt" system of state mutual fund regulation hurts investors. First, it needlessly duplicates, and often undermines, the SEC's national initiatives to improve investor protection. Perhaps the best example of this problem is in the area of communications with investors. While the mutual fund industry and the SEC have recognized the importance of ensuring that prospectuses and other written communications are clear, concise and accessible, efforts in this regard are frustrated by a system that allows individual state regulators to demand adherence to their own unique disclosure requirements. The result is often a prospectus that is unduly long, complex and difficult to comprehend.

Second, the current system hinders innovations in products and services that are permitted by federal law and beneficial to investors. In this regard, I am concerned that many of the provisions of H.R. 1495 that are intended to facilitate product innovations, such as those providing more flexibility with respect to the creation of "funds of funds," will come to naught as a result of the objections of even a single state regulator. There also is great concern within the industry that one or more states will impede the growth of electronic communications as a means of disseminating information to shareholders, notwithstanding the fact that the SEC has just issued a release endorsing this trend and setting forth national standards in this area.[14]

Third, the system imposes undue compliance burdens on funds. Many fund groups must employ special staffs dedicated to complying with the myriad varieties of state regulation. This is in addition to the demands on other legal and compliance personnel within fund organizations, who invariably must devote a portion of their time to state regulatory matters, as well as the need to retain outside counsel in many cases.

Finally, the existing system diverts state resources away from enforcement and education, areas where state involvement clearly benefits investors. Reviewing fund prospectuses and advertising, and otherwise duplicating actions undertaken at the federal level, is an inefficient use of these limited resources.

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[12] SEC Form N-1A, Instruction G.

[13] Funds that are not affiliated with an NASD member file their advertisements with the SEC.

[14] Investment Company Act Release No. 21399 (Oct. 6, 1995).

D. Recommendations for Change

The mutual fund industry has devoted years to attempting to remedy this problem at the state level. We have worked with the states, both individually and collectively through North American Securities Administrators Association ("NASAA"). Unfortunately, these efforts have been unavailing.

Thus, we have concluded that this national problem requires a national solution—which only Congress can provide. We are aware that NASAA recently has announced a Task Force on federal-state securities regulation. The Task Force has a distinguished membership. The Institute looks forward to working with it and welcomes its efforts to address, on a wide-ranging basis, the problems posed by the current dual system of regulation. I must emphasize, however, that at least in the case of mutual funds, much study already has been done—including by NASAA. The problems with state regulation of mutual funds, and the harmful consequences for investors, are well documented—and the solution is clear. Not more study and delay, but prompt Congressional action, is required.

Specifically, the Institute urges that the review of mutual fund prospectuses and advertisements be lodged exclusively with the SEC and NASD, and that investment limitations be established exclusively at the federal level. The valuable role states play in other aspects of securities regulation, such as enforcement and education, should be preserved. Accordingly, the mutual fund industry does not object to paying state fees and making notice filings. We note that SEC Chairman Levitt recently endorsed this very solution, stating that it "makes a great deal of sense" and constitutes "a good beginning on which to build a broader agreement" regarding federal and state roles in securities regulation.[15]

The Institute submits that this approach to mutual fund regulation would promote many of the goals of modernizing the mutual fund regulation, thereby benefiting investors throughout the nation. It would facilitate mutual fund communications with investors, encourage innovation in mutual fund products and services and allocate in a sensible and cost-effective manner the limited resources of federal and state governments. Indeed, this model of mutual fund regulation already has been adopted in a number of states, to the benefit of their citizens. By enacting legislation that adopts such a regulatory scheme nationwide, Congress can ensure that investors in all 50 states receive the full benefits of this rational approach to mutual fund regulation.

In closing, we commend the Subcommittee for considering legislation that would modernize the Investment Company Act and the securities laws in general. One can expect that some issues before the Subcommittee may require more consideration and study than others, but none has been more carefully studied and documented already than the problems caused by the dual federal-state regulation of mutual funds. The need for Congressional action to resolve these problems is widely recognized—as is the nature of the action Congress must take. We therefore respectfully ask the Subcommittee, as you consider all of the issues associated with modernizing the securities laws, to retain the option of addressing the problem of dual federal-state regulation of mutual funds in the context of H.R. 1495.

We will work with you to ensure success because resolution of this issue is our number one priority. The Subcommittee has provided a tremendous opportunity to enact legislation that will modernize the Investment Company Act both to make it more effective and to better protect investors. [Additional material submitted is retained in subcommittee files.]

Mr. FIELDS. Thank you, Mr. Fink.

Mr. Don Powell, Chief Executive officer of Van Kampen American Capital.

STATEMENT OF DON G. POWELL

Mr. POWELL. Chairman Fields and members of the committee, thank you for the opportunity to testify regarding H.R. 1495 and other matters related to the regulation of mutual funds. My name is Don Powell. I am the president and CEO of Van Kampen American Capital, which is headquartered in Houston and Chicago. We

[15] "The SEC and the States: Toward a More Perfect Union," Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, at the Annual Conference of the North American Securities Administrators Association, Vancouver, British Columbia (October 23, 1995), at p. 5.

manage about $54 billion in assets and our fund family includes 36 mutual funds, 38 closed-end funds and 2,800 limited investment trusts. Together, these funds serve about two million shareholders in all 50 states, Puerto Rico and the District of Columbia.

Mr. Chairman, I would particularly like to thank you for introducing legislation to modernize the mutual fund regulation and today I would like to focus on one of these major areas which is communications between mutual funds and their shareholders.

We believe there are some obstacles that Congress and the SEC need to address. H.R. 1495 recognizes that communications between mutual funds and their shareholders take place along a broad spectrum and these include such things as advertising, periodic reports, prospectuses and now the Internet and I would like to briefly touch on each of these four items.

First, there is a need for flexibility in the forms that fund advertising may take and Section 3 of your bill would provide this necessary flexibility and I strongly support the intent of this provision. Second, mutual fund periodic reporting requirements should be improved and Section 5 addresses this issue by giving the SEC more flexibility in setting the requirements for these reports. I think it is important to remember that improving the quality of the information of these reports and not necessarily increasing their volume or their frequency should be the goal. In other words, less can be more.

Third, we need to improve the mutual fund's key disclosure document, the prospectus. A frequent complaint, as you have already heard, is that prospectuses are too long, they are too cumbersome and they are too legalistic and for this reason, many fund families, including Van Kampen American Capital have tried to simplify their prospectuses.

One problem that we face that has been alluded to many times is this area of duplicative regulatory review of all of our prospectuses. These must be submitted, reviewed and cleared not only by the SEC but by also some 30-odd state securities commissions and, as Mr. Fink has already pointed out, each state can object to the language which has been reviewed by the SEC and insist on additional disclosure. I hope that Congress can address this issue by lodging exclusive authority over fund prospectuses with the SEC.

Another initiative being pursued by the mutual fund industry is the so-called profile prospectus. This project, which was developed jointly at the initiative of SEC Chairman Levitt, by the SEC, the Investment Company Institute and the North American Securities Administrators Association, is currently in the pilot phase. The profile prospectus is a concise, two- to three-page document that summarizes the most important information about a fund. The use of a standardized format makes it easy for investors to understand a particular fund and to compare funds.

The profile prospectus holds great promise for simplifying mutual fund disclosure while at the same time making sure that investors have a document that many will actually read and understand. Congress should take steps to ensure that the profile prospectus can be used by itself and that authority over the contents of the profile prospectus is reserved exclusively for the SEC.

Finally, Congress and the SEC should act to ensure that mutual funds offer products and services through electronic and other media. A recent institute survey showed that something like 56 percent of our shareholders have a personal computer at home and, of these, half subscribe to an on-line computer service. In increasing numbers, funds are establishing Web sites, home pages and presences on line. The SEC under the leadership of Chairman Levitt has recognized the potential uses of the telecommunications technology and has sought to facilitate the use of electronic media.

I am concerned, however, that even here some states may not be as willing to accommodate the electronic document delivery and I hope that Congress will help ensure that mutual funds can effectively use this new technology in communicating with investors.

I appreciate the opportunity to discuss these important issues with you and will be happy to answer any questions the subcommittee may have.

[The prepared statement of Don Powell follows:]

PREPARED STATEMENT OF DON G. POWELL, PRESIDENT AND CEO, VAN KAMPEN AMERICAN CAPITAL, INC.

I. INTRODUCTION

Chairman Fields and Members of the Subcommittee: Thank you for this opportunity to testify concerning H.R. 1495, the "Investment Company Act Amendments of 1995," and other matters related to the regulation of mutual funds.

My name is Don Powell and I am President and CEO of Van Kampen American Capital, Inc. Van Kampen American Capital is headquartered in Houston and Chicago and manages or supervises $54 billion in assets. Our fund family includes 36 open-end mutual funds, 38 closed-end funds, and 2,800 unit investment trusts. Together, these funds serve 2 million shareholders. Our funds are sold through independent sales forces in all 50 states, Puerto Rico, and the District of Columbia. We employ almost 1,300 individuals—about 500 in Houston and 400 in Oakbrook Terrace, Illinois, with the remainder in Kansas City, Missouri, New York, and elsewhere.

Mr. Chairman and Congressman Markey, I particularly want to thank you for introducing legislation to modernize and improve mutual fund regulation in the United States. Although the U.S. system of mutual fund regulation has served investors well, there are a number of areas where improvements are necessary. I wish to focus on one area that I believe to be of particular importance to the mutual fund industry and the shareholders we serve. This is the need of all mutual funds to be able to communicate with their shareholders and other investors as clearly and as effectively as possible. While there is much that the mutual fund industry can and is doing on its own to improve shareholder communications, there are obstacles that Congress and the Securities and Exchange Commission need to address.

II. SHAREHOLDER COMMUNICATIONS

A. Advertising and Sales Literature

The SEC, the mutual fund industry, and investors all want to improve the quality of communications between funds and shareholders. For our fund group, the rationale is simple: We want investors to understand what they are buying. We believe that they are more likely to be satisfied with their investment results if they have appropriate expectations about performance and risks. For investors the rationale is also clear: They want more user-friendly information on which to base their buying decisions.

H.R. 1495 recognizes that communications between mutual funds and shareholders take place along a wide spectrum, including advertising, periodic reports, prospectuses, and, now, the Internet. My testimony today will address all four of these media. First, I would like to talk about improvements that can be made in fund advertising. Section 3 of the bill addresses this issue in a very helpful way.

As you know, the federal securities laws and the SEC's rules impose detailed and strict requirements on mutual funds' activities. In addition to restrictions on leverage, limits on transactions with affiliates, and corporate governance standards that

go beyond the requirements of state corporate law, these requirements include detailed standards on advertising and other matters.

The current system of disclosure significantly limits the forms investor communications may take. The system essentially revolves around the statutory prospectus. The Securities Act requires that every prospective investor receive a copy of a fund's prospectus. The SEC has promulgated detailed requirements about the format and content of the prospectus. A second document, the statement of additional information, or "SAI," contains other, less important information and must be made available to investors upon request.

All information about a fund other than the prospectus and the SAI must fall into one of three categories. First, an advertisement can take the form of a "tombstone," which contains certain specific, limited information about the fund. Second, it can take the form of sales literature that may contain additional information if it is accompanied or preceded by the prospectus itself. Third, it can be an advertisement that is limited to information "the substance of which" appears in the prospectus. The first of these categories is extremely narrow and allows for too little information to be helpful; the second category entails significant expense because it requires that a prospectus accompany any such materials.

Superficially, the third alternative—using materials "the substance of which" is in the prospectus—should be very helpful. In fact, it too is very restrictive. The problem is that much information that investors would find helpful, such as performance information, may be used in sales literature only if they are first incorporated in the prospectus. This adds length and can burden an already crowded prospectus.

Section 3 of H.R. 1495 attacks this problem by permitting funds to use sales literature that is not limited to information in the prospectus. I strongly support the intent of this provision.

B. Periodic Reports

As part of the goal of promoting more effective communications with shareholders, mutual fund periodic reporting requirements should also be improved. Section 5 of H.R. 1495 addresses this issue by giving the SEC more flexibility in setting requirements for these reports. Improving the quality of information in these reports, not increasing their volume or frequency, should be the goal—less can be more. Too much detail or volume can be confusing and uninformative to shareholders.

Under the SEC's current rules, every mutual fund must send shareholders a semi-annual and an annual report. These reports must include management's discussion of fund performance; a statement of net assets, including a list of each investment held by the fund; a statement of operations; a statement of changes in net assets; a financial highlights table for the past ten years; and a number of other types of information. Much of this information goes beyond what is required by generally accepted accounting principles. In addition, some of the data is little understood by shareholders.

I believe that some of the information now required could be eliminated without impairing shareholders' understanding of a fund's operations. As one example, the list of a fund's investments, which can run more than twenty pages for some funds, could be shortened by limiting disclosure to the fund's twenty-five largest holdings or to any investment that amounts to more than one percent of the fund's assets. A full list could be made available to those shareholders who request it.

C. Prospectus Improvements

1. Simplification—A frequent complaint is that prospectuses are too long, too cumbersome, and too legalistic. For this reason, many fund families, including Van Kampen American Capital, have pursued prospectus simplification. A concerted effort is being made to shorten prospectuses, eliminate legalese, and emphasize the most important information.

One problem we face in this area is the need to obtain duplicative regulatory review of all our prospectuses. These must be submitted, reviewed, and cleared not only by the SEC staff but also by each of thirty-odd state securities commissions. Each of these agencies can object to new language or decide that some disclosure which we thought could safely be eliminated must be restored. I should note that I have frequently heard that a state agency demanded additional disclosure, more prominent disclosure, or disclosure moved to the cover page. I have never heard of an agency commenting that a particular disclosure was too long, was completely unnecessary, or should be moved to the back.

2. The Profile Prospectus—One initiative being pursued by the mutual fund industry to simplify and improve disclosure to investors is the so-called "profile prospectus." The profile project was developed jointly, at the initiative of SEC Chairman

Levitt, by the SEC, the Investment Company Institute, and the North American Securities Administrators Association. The project is currently in a pilot phase, with eight fund groups participating.[1] The profile prospectus is a short, two-to-three page document that summarizes the most significant information about an investment in a fund. The information includes: (1) the fund's investment objective, (2) its investment strategies, (3) material risks, (4) appropriateness of the fund for particular investors, (5) its sales charges and fund expenses, (6) the fund's past performance, including a bar chart showing performance in each of the last ten years, (7) the identity of the fund's investment adviser, (8) how to make purchases, (9) how to make redemptions, (10) dividend information, and (11) other services. I have attached some representative examples.

The profile prospectus brings together, in a concise format, the most critical information investors need to know about the fund. In addition, the use of a standardized format makes it easy for investors to compare one fund with another, or with several others. The profile prospectus holds great promise for simplifying mutual fund disclosure while at the same time making sure that investors have a document that many more will actually read and understand. The Institute currently is engaged in a consumer research project to gauge investor reaction to the profile prospectus. We expect it to be highly favorable. Two regulatory hurdles remain. First, the SEC to date has approved the use of a profile prospectus only in conjunction with the full fund prospectus. I believe that the profile prospectus can responsibly and beneficially be used by itself, so long as all investors, if they wish, are able to request and receive a complete prospectus in advance of any investment and so long as all investors receive a copy of the full prospectus automatically with confirmation of their purchase.

Second, even if the SEC agrees to permit the use of the profile prospectus on a stand-alone basis, state regulation undoubtedly will create problems. In the disclosure area, the SEC currently does not have exclusive authority, and profile prospectuses likely will bear little resemblance to what Chairman Levitt intended following state review and comment. At least some states are not likely to permit the profile to be used alone, even if this use is approved by the SEC. There is precedent for this. In 1983, when the SEC first separated disclosure into a prospectus and a statement of additional information, some states required that all investors receive the SAI even though the SEC required only that it be provided upon request. It is also possible that individual states will adopt their own requirements as to what is included in the profile, just as some states require specific disclosure on the cover page of a prospectus beyond what the SEC requires. Congress should take steps to ensure that the profile prospectus can be used by itself and that authority over the contents of the profile prospectus is reserved exclusively for the SEC.

3. *Risk Disclosure*—The mutual fund industry has focused particularly on improving investor understanding of the risks of mutual fund investments. We believe that complete disclosure of risk is essential to maintaining the broad confidence of the American investing public in mutual funds. Currently, there is one proposal to "shortcut" shareholder communication and "simplify" prospectus disclosure of risk that, in my view, should be rejected. This is a proposed requirement that all fund prospectuses disclose a numerical measure of risk. This approach is fundamentally flawed because it rests on the incorrect assumption that there is some single, objective measure of investment risk. Instead, risk is a complex concept, not susceptible to easy quantification. Moreover, the use of a single government-mandated measurement may in fact mislead investors who do not understand the limitations of the measurement or who cannot evaluate its relevance to their own situation. As just one example, an equity fund in general poses more short-term risk than does a fixed-income fund. Yet most financial advisers would tell a thirty-year old trying to decide which of the two funds to purchase for his 401(k) plan that his risk of having insufficient retirement savings is greater if he buys the fixed-income fund. Thus, a risk measure based on short-term volatility would not be appropriate for such an investor.

A far better approach would be to require concise narrative disclosure, along with a bar chart showing a fund's year-by-year performance. This is the approach taken in the profile prospectus project. For example, the following bar graph illustrates how key aspects of risk can be disclosed in visual terms—i.e., that an investment can go up and down over time, that the investor can lose as well as make money, and that a longer-term perspective is appropriate.

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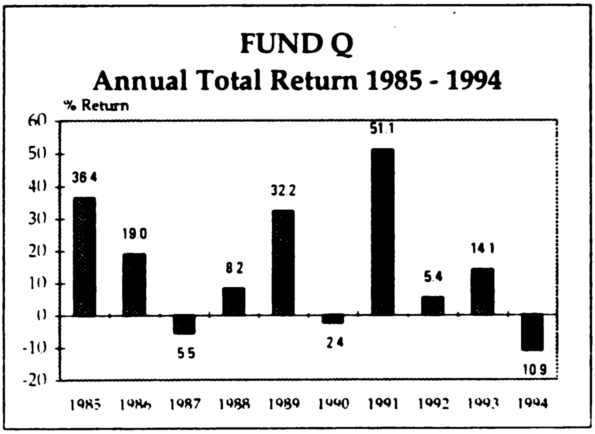
[1] These are: American Express Financial Corp. (IDS Funds), Bank of America (Pacific Horizon Funds), Capital Research & Management Co. (American Funds), Dreyfus Corp., Fidelity Investments, T. Rowe Price Associates, Scudder Stevens & Clark, and The Vanguard Group.



FUND Q

Average Annual Total Return

Past 1 year	-10.9%
Past 5 years	11.5%
Past 10 years	14.8%

For fiscal periods ended December 31 1994

D. Electronic Information Dissemination

Finally, Congress and the SEC should act to ensure that mutual funds are able to offer products and services through electronic and other media. Efforts to improve shareholder communications through the use of new technologies should be encouraged by the federal securities laws. Preliminary data from an Institute survey of 1,500 mutual fund shareholders indicates that investors have clearly entered the new "information age." Fifty-six percent have a personal computer at home, and approximately one-half of them subscribe to an on-line computer service. In increasing numbers, funds and other providers of financial services are establishing web sites, home pages and presences "on-line" to communicate with investors and shareholders. The SEC, under the leadership of Chairman Levitt and Commissioner Wallman, has recognized the potential uses of computer and telecommunications technology and has sought to facilitate the use of electronic media to provide disclosure documents. For example, the SEC's recent releases on the use of electronic media state that a mutual fund could make supplemental sales literature available on the Internet so long as the literature contains "hyperlinks" to the fund's electronic prospectus.

The SEC's releases are very helpful. They clearly reflect the potential value of these new services to investors. Irrespective of the SEC's policies, however, the availability and utility of such services to mutual fund investors depends on the judgment of state securities regulators—a matter of some concern in view of the inconsistency and conflicts that our dual regulatory system has occasioned in other contexts. I am concerned, for example, that (in contrast to the SEC) some states might not consider electronic access to a prospectus to constitute delivery. In cyberspace, as elsewhere, the mutual fund marketplace is a national one—and, if it is to serve investors best, it requires national standards set by the SEC. Congress, in my judgment, should give the SEC the necessary authority to set such standards.

I appreciate this opportunity to discuss these important issues with you. I would be happy to answer any questions the Subcommittee may have.

Mr. FIELDS. Thank you, Mr. Powell.

Mr. James Riepe, Managing Director, T. Rowe Price Associates.

STATEMENT OF JAMES S. RIEPE

Mr. RIEPE. Thank you very much, Mr. Chairman.

My name is James Riepe, I am a managing director of T. Rowe Price, a Baltimore-based investment management firm that serves as an investment advisor for the T. Rowe Price family of funds. I have been actively involved in the fund industry for over 25 years and served as chairman of the Investment Company Institute for 2 years. I am also a member of the Board of the NASD and Chair-

man of its Investment Companies Committee and I, too, am very pleased to be here today.

Founded over 55 years ago, T. Rowe Price now manages over $70 billion of assets. Some 46 billion of that is contained in 70 no-load mutual funds that belong to some nearly four million accounts. Price Associates' operations are based in Baltimore but we also have shareholder servicing operations in both California and Florida. We distribute our funds nationally.

I, too, would like to join my fellow panelists in commending the Chairman and Congressman Markey on H.R. 1495. While we believe the Investment Company Act has served investors well and has played a very major role in the growth of the fund industry, there is no question that the proposed bill includes several provisions that we believe will enhance the ability of the fund industry to continue its tradition of offering innovative products which will better serve investors.

One particularly interesting innovation in the bill which has already been discussed this morning is the UFIC proposal, originally recommended by the SEC staff in its 1992 report on investment company regulation. A UFIC or a unified fee investment company is a single-fee fund under which all fund expenses are paid out of a single fee which would be prominently disclosed, I might add, to investors. The fee, rather than being set by the fund directors, would be established by the fund's advisor at the time the fund was formed. Given the highly competitive nature of the fund industry, which has resulted in many funds adopting fee caps or their own variations on the single fee concept, the marketplace will ensure that such fees are set at competitive levels.

The UFIC proposal offers a number of important benefits. First, I think investors will be able to invest in funds that have very predictable annual expenses which can be easily compared to other funds. Second, fund directors who importantly will retain all of their other responsibilities under the Investment Company Act, will be able to focus on core functions, such as guarding against conflicts of interest, monitoring investment performance and others. Third, the UFIC structure is similar to how funds are priced overseas. This may enhance the fund industry's competitiveness since they would be using the same structure here and abroad. Then, last, it would eliminate fluctuations in expense ratios for funds that adopt this structure, which would make it easier for fund investors to understand the costs of a fund.

While we strongly support the concept of UFIC, in my written testimony we have recommended a few changes which we think will better enable it to achieve its intended results. The bill also provides relief for a fund-to-fund, subject to certain conditions which Mr. Barbash discussed. Price Associates currently offers two such funds of funds which, in just 5 years, have proven to be very popular with investors to the tune of over $2 billion.

Within the past few weeks, the SEC has issued an amended order removing some of the very stringent limitations that were originally imposed on these funds. The fund-of-funds provision in the bill in effect codifics the SEC's current views of these funds. We strongly support its enactment as it would eliminate unnecessarily

cumbersome requirements and it would obviate the need for fund groups such as ours to seek individual SEC exemptive orders.

Our industry has also been very innovative in the area of shareholder communications. In this regard, I would like to join Mr. Powell in saying that the subcommittee's attention to the profile prospectus is very important to us. Price Associates is a participant in the pilot project to develop a short form document containing key information about a fund in a standardized format. We are hopeful that following completion of this pilot program, the SEC will permit the use of the profile as a stand-alone document with investors being given the option of receiving the full statutory prospectus before making an investment decision.

Federal/state regulation, as Mr. Fink indicated, is of tremendous importance not only to the industry but to T. Rowe Price. Presently, a number of states are endeavoring to regulate not only the offering materials of mutual funds sold in their state but in many cases the actual investment policies and internal operations of these funds as well. The end result is an odd one in that any one state has the capacity to dictate a national standard and that one standard may, in fact, conflict with the SEC's policy.

All of these areas of our fund activities are already regulated in a very thorough and effective manner on a national basis by the SEC and the NASD. To me, the record is very clear. Since the adoption over 50 years ago of the Investment Company Act, the SEC's regulation of funds has helped to produce the fund industry, remarkably free of fraud and scandal and one that has met with overwhelming popularity of the investing public.

Funds and their advisors expend substantial human and financial resources in complying with duplicative, individual state regulation. Reserving exclusive authority over mutual fund regulation at the Federal level would sharply reduce the unnecessary burden on fund organizations that results from duplicative and often conflicting state requirements and it would do this, I might add, without reducing investor protections. In fact, mutual funds pay more than $100 million a year in fees to the states in support of their efforts to police fraud and sales practice.

I would end with that, Mr. Chairman, and thank you again for the opportunity to testify today.

[The prepared statement of James S. Riepe follows:]

PREPARED STATEMENT OF JAMES S. RIEPE, MANAGING DIRECTOR, T. ROWE PRICE ASSOCIATES, INC.

My name is James S. Riepe. I am a Managing Director of T. Rowe Price Associates, Inc., a Baltimore-based investment management firm that serves as an investment adviser to the T. Rowe Price family of no-load mutual funds and to individual and institutional clients. I have been actively involved in the mutual fund industry for over 25 years. From 1990 to 1992, I served as Chairman of the Investment Company Institute, the national association of the investment company industry. In July 1991, I was appointed by Securities and Exchange Commission Chairman Richard Breeden to the Market Oversight and Financial Services Advisory Committee. I am currently a member of the Board of the NASD and Chairman of its Investment Companies Committee. I welcome and appreciate the opportunity to appear today.

T. Rowe Price now manages some $72 billion in assets, $46 billion of which is in 70 no-load mutual funds held in nearly 4 million investor accounts. The Price Funds include 25 equity funds, 14 income funds, 19 municipal bond funds and 12 international funds. With the exception of 11 state specific municipal bond funds, these Funds are sold in all 50 states. Currently, T. Rowe Price Associates has over 2,000

employees, 1,800 of whom work in the Baltimore metropolitan area. We also have shareholder servicing operations in Los Angeles, California and Tampa, Florida.

Founded over 55 years ago, T. Rowe Price Associates is one of the oldest and largest distributors of no-load mutual funds. Its funds are marketed directly to investors who, in turn, purchase shares of the funds directly from T. Rowe Price. These investments are made in both regular and qualified retirements accounts such as IRAs.

In addition, T. Rowe Price provides its mutual funds and recordkeeping services to more than 700 defined contribution plans sponsored by corporate and public employers. This fast growing mutual fund constituency is now made up of more than 750,000 plan participants investing through their employer in T. Rowe Price Funds.

With more than 6,000 funds available, the mutual fund industry is highly competitive and is known for the innovative developments that it has brought to the investing public in the past. These initiatives have resulted in a wide array of investment options and services being made available to investors. T. Rowe Price in particular was one of the first fund groups to offer a variety of international funds and to offer its funds to workers saving for their retirement through defined contribution plans.

We wish to commend Chairman Fields and Congressman Markey on HR 1495, The Investment Company Act Amendments of 1995. This bill includes several provisions designed to enhance the ability of funds to develop further innovations and thereby continue our tradition of being responsive to the needs of investors. Two provisions in particular that I will discuss are those concerning the so-called "unified fee investment companies" and "funds of funds". I will also discuss the industry's innovations in shareholder communications, including simplified prospectuses and electronic communications.

One potential roadblock to these and other innovations is the archaic and costly system of overlapping federal and state regulation of mutual funds. Thus, my testimony will also discuss problems that result from this system and the serious need for reform.

The Unified Fee Investment Company

Section 6 of the Investment Company Act Amendments of 1995 provides for an innovative new form of investment company structure that will be of significant benefit to investors. It is referred to as a UFIC and is an "all in" or unified fee investment company. The unified fee concept, which has been suggested in various forms since 1980, has now developed into a form which combines the best features of the current governance structure of both U.S. and foreign mutual funds. It would provide investors with the ability to invest in a fund with a predictable annual cost which could be easily compared with the cost structure of other funds.

The idea of the UFIC, which was included as a recommendation in the 1992 SEC staff report on investment company regulation, is a simple one. The internal cost or pricing of the mutual fund would be set by the investment adviser or creator of the product in the same manner that the price or investment yield is determined for most other financial products such as variable annuities and other insurance products. This price, meaning the day to day expenses of the fund including the investment advisory fee, would be set by the adviser as a fixed percentage of assets and cover all expenses. This would be an "all in" fee and is the reason for the name unified fee investment company or UFIC.

This is the way most mutual funds are priced in the rest of the world and differs from the present U.S. structure where most fixed costs depend on the actual dollars charged for various services during the year resulting in a variable expense ratio. The other principal difference is that the market, rather than the board of directors, sets the fee. This structure offers investors a significant advantage—it enables them to easily and accurately compare the costs borne by competing funds.

Like traditional mutual funds, a UFIC would have a board of directors, including directors unaffiliated with the sponsor. Their boards would fulfill exactly the same role they now do except for one thing. They would no longer be responsible for annually negotiating the "price" of the product or management fee with the adviser. The overall fee would be set by the adviser as dictated by the marketplace. Investors would be able to see the price stated as a fixed expense ratio and, most importantly, compare it with the "unified" price of other UFICs, and the expense ratios of traditional mutual funds.

With thousands of funds offered by hundreds of different advisers, the mutual fund industry has become very competitive. A fund with an excessive expense ratio will not be competitive and, therefore, will not attract meaningful assets if investors have alternatives. Accordingly, there is every reason to have an optional structure allowing the adviser to set its "price" and permit investors to make their own deci-

sion as to whether the price is reasonable, rather than having the directors perform an annual negotiation on their behalf.

Indeed, perhaps the best evidence of the competitive nature of the marketplace as it concerns fees is the fact that many funds today impose voluntary caps on their expenses, especially during the early years of a new fund, when expenses tend to be higher. An expense cap is used to make funds competitive that would not otherwise be so. Within our fund group, about one-third of our funds have an expense guarantee, under which we set a cap on expenses and absorb any fund expenses that exceed that level.

With the exception of negotiation of fees, the important responsibilities of UFIC directors would otherwise remain as they are in the current structure. That is, they would be responsible for the overall monitoring of the business conduct and investment activities of the adviser, policing conflicts of interest and correcting bad practices, such as the misuse of brokerage and violations of codes of ethics. The directors also would remain available to resolve disputes and allocate liability between the fund's adviser or other service providers.

We support the concept of a UFIC and believe it could offer several important benefits for shareholders of funds that elect to adopt the structure. (I should stress that the UFIC is only an optional structure and that it would in no way affect the operations of traditional mutual funds.) First, it would enhance the ability of investors to "price shop" among various funds. Second, in view of the increasing demands on fund directors, it would allow directors to focus more on core responsibilities, such as preventing conflicts of interests and monitoring the funds' activities, while leaving economic considerations to the marketplace. Third, as more fund groups seek to offer shares overseas, there will be efficiencies and cost savings from being able to use a similar pricing structure for domestic and foreign funds. And fourth, for smaller funds which choose to adopt this new structure, it will eliminate fluctuation in expense ratios caused by rising and falling asset levels.

Nevertheless, several changes are needed in the present version of the bill to allow the UFIC design to efficiently achieve its intended results. First, we do not believe that the statute should delegate responsibility over the single fee to the directors, even in the more limited fashion provided in the bill. This provision misses one of the basic points of the UFIC concept which is to let the market and investors decide the economic "pricing" question. Moreover, it could be a source of open-ended liability to fund directors.

Other suggested changes would include: permitting the registration of a UFIC without prior SEC rulemaking or order; providing for conversion of an existing fund into the UFIC form with the approval of shareholders; clarifying the directors' responsibility in renewing the advisory contracts; and extending the ability to use the UFIC form to front-end load funds. In addition, in order to further the "fixed" nature of the single fee, we recommend that, in general, increases in the single fee be subject to shareholder approval.

Fund of Funds

The second proposed innovation in the bill on which I will comment is the so-called "fund of funds". Specifically, Section 9 recognizes that there is a very useful role for various types of funds of funds. Indeed, T. Rowe Price offers two such funds, which permit investors to have their investment dollars allocated among several underlying funds in our group. Our experience, plus $2 billion of shareholder investments, conclusively show that investors do benefit from and appreciate guidance on allocating their investments among different types of funds through a fund of funds. Just in the last few weeks, the SEC issued an order removing several unnecessary restrictions on these funds. In many respects, the SEC's viewpoint is similar to Section 9 of the bill. Accordingly, we support this provision of the bill as enacting into law the SEC's current views on the subject, which would make it unnecessary for T. Rowe Price and other fund groups to obtain exemptive relief in order to offer this practical service.

Profile Prospectuses and Technological Advances

I would like to turn to another area of regulatory innovation where the mutual fund industry and the SEC are actively working, namely, the simplified prospectus, telecommunications and electronic technologies.

An example of the simplified prospectus initiative is the "profile prospectus" which is now in a pilot phase. The profile is a short-form document that is written in plain English, and has a mandated format and content. It has been designed to benefit investors by simplifying and standardizing prospectus disclosure and thereby facilitating the review and comparison of different funds. We have participated with several other fund groups and the SEC in this pilot project, under which the profile

must accompany the full prospectus. Our initial results are encouraging with favorable responses from investors. Ultimately, in order to realize the full benefit of this initiative, the profile prospectus should be allowed to stand alone, i.e., not be accompanied by the full prospectus. In such a case the investor could still request a full prospectus prior to making an investment and would receive one in any case with his or her confirmation of sale.

We and other fund groups are also exploring electronic advertising and the delivery of prospectuses and fund reports through the Internet and commercial on-line services. The SEC is cooperating in this endeavor, having recently issued an interpretive release and prospective rule changes designed to permit and encourage these initiatives.

However, these and past SEC initiatives, although of general benefit to investors, have and can be expected to continue to be frustrated by the present ability of any one or more states to second guess the national solutions and requirements worked out by the SEC. This problem has been and continues to be a serious one and leads into my final subject.

Overlapping Federal-State Regulation of Mutual Funds.

Federal-State regulation is an area which is of great importance to T. Rowe Price, but more importantly to the entire mutual fund industry and its shareholders. Presently, a number of states are endeavoring to regulate not only the offering material of mutual funds sold in their state, but in many cases, the investment policies and internal operations of these funds as well. Both of these areas are already regulated in a very thorough and effective manner on a national basis by the SEC and the NASD. The record is very clear that SEC and NASD regulation of mutual funds has produced a fund industry remarkably free of fraud and scandal.

Mutual funds and their advisers expend substantial resources both in dollars and time in attempting to comply with individual state disclosure requirements which may differ not only among states but with the SEC as well. Our Legal Department currently must commit a significant portion of the time of three attorneys, one compliance officer, one securities paralegal and four blue sky paralegals to comply with these state requirements. In order to meet the demands of particular states, we have often had to change the text of our universal fund prospectuses used nationally or else attach special "stickers", supplements or legends to the prospectuses sent into those states.

Reserving exclusive authority over mutual fund prospectus disclosure to the SEC, as is contemplated in the Capital Markets Reform Bill introduced by Chairman Fields, would sharply reduce the unnecessary burden on fund organizations that results from the duplicative and conflicting state disclosure requirements. Even more importantly it would eliminate investor confusion arising from different and often conflicting disclosures by prescribing a common national prospectus. It stands to reason that mutual fund prospectuses and other offering material that meet the standards mandated by Congress and implemented by the SEC and NASD should be just as protective of investors in Texas as they are in Massachusetts. The crazy quilt of current disclosure requirements clearly does not increase investor protection.

Another problem concerns mutual fund advertising. T. Rowe Price, as a direct-marketed fund complex, does not rely on commissioned salespeople, but rather offers its funds directly to investors, free of sales charges. Accordingly, it relies heavily on written advertising to reach prospective investors. This material is subject to strict rules under the securities laws and is filed with, and reviewed by, the NASD. Nevertheless, a handful of states require us to also file our advertising with them and one state actively reviews and comments on advertising. Earlier this year, this state promulgated its own standards for prospectus "wrappers" that differ from those of the NASD. Because it is difficult to segregate the wrappers provided to investors in this state from those provided to investors in other states, funds have had to follow this state's requirement for *all* prospectus wrappers. Thus, in this way, a single state has been able to dictate a nationwide standard.

In addition to overlapping state and federal disclosure regulations, many states subject mutual funds to their own substantive requirements, such as specific investment restrictions. As stated previously, it is clear to all that the 1940 Act is both thorough and complete in its regulation of mutual funds; moreover, the SEC has a substantial and knowledgeable Investment Management Division that successfully carries out the purposes of that Act. The 1940 Act is very specific concerning substantive operational requirements including adherence to stated objectives and policies. For example, a mutual fund is limited with respect to its borrowing or leveraging ability and its capital structure. Transactions with affiliates are either

prohibited or strictly regulated. Certain investment policies must be stated and can be changed only with a shareholders vote.

The point is that a mutual fund's structure, operations and investment policies are thoroughly regulated on a national basis by the 1940 Act and the regulations and policies of the SEC. Since its adoption over 50 years ago, this national regulatory structure has proven to be a resounding success for the investing public. The additional substantive requirements that many individual states have imposed, such as diversification requirements, policies with respect to options and futures, and expense limitations, have neither provided nor resulted in any improvement over those mandated by the 1940 Act.

The bottom line is that state regulation in this area hasn't added anything to investor protection. In fact by forcing such requirements on a fund one of two things happen, neither of which is good for the investors or the nation at large. Either the fund complies with the state's policy, with the result that the state has effectively dictated policy for the nation at large, or the fund is not sold in that state.[1] This alternative deprives the investors in that state of the opportunity to make their own choice.

I wish to emphasize that the industry does not object to paying its fair share of fees to the states to support their efforts to police fraud and sales practice abuses. We believe that state regulation can and should continue to play a critical role in this area. Indeed, by not utilizing resources to duplicate the efforts of the SEC and NASD, state efforts in these areas could be enhanced.

It is very difficult to believe that if Congress were starting de novo today to regulate the mutual fund industry that it would design the present overlapping, costly and burdensome federal-state structure that provides no additional benefits or protections for investors. I strongly urge you to take this opportunity to address the counterproductive aspects of this current dual system of federal/state regulation while preserving at the same time its best features.

Conclusion

We are very proud of our mutual fund industry and its incomparable record of serving the investor. We believe that by making the improvements with respect to mutual funds proposed in HR 1495, we will succeed in continuing this record in the future.

Mr. FIELDS. Thank you very much.

Ms. Marianne Smythe, partner of Wilmer, Cutler and Pickering. I hope I pronounced your last name correctly.

STATEMENT OF MARIANNE SMYTHE

Ms. SMYTHE. Yes, sir, thank you. And thank you very much for asking me to be here today.

My name is Marianne Smythe and I am a partner at the law firm of Wilmer, Cutler and Pickering. Before joining that firm 2½ years ago, I was the director of investment management at the SEC and I feel it is a great honor to be asked to appear before you today and really a privilege to be here with this distinguished panel.

Mr. Chairman, I believe that you and the subcommittee deserve enormous credit for introducing legislation that would sweep cobwebs off of the 55-year-old Investment Company Act. I would add that I am 53 years old and probably could use some cobweb sweeping myself.

There are many commendable features of H.R. 1495 and I have been asked to testify concerning just one of those, the amendments that would exempt from regulation under the act investment companies owned by qualified investors. My firm represents Tiger Management Corporation, a registered investment advisor and

[1] In some circumstances states will waive compliance with a state substantive requirement in exchange for special disclosure in the form of a sticker on the cover of the prospectus. Clearly this is not useful to investors and is a burden to the fund.

Tiger, two of whose officials are behind me today, strongly supports these amendments which would free private investment companies that are open exclusively to qualified investors from unnecessary regulation.

I want to make clear at the outset that we don't advocate nor does this legislation advance the wholesale abrogation of the Investment Company Act of 1940 and no one should seriously dispute that statute's efficacy through the years in offering substantial protections to investors, nor should anyone doubt the continued validity of that law for the overwhelming majority of investors.

For qualified investors, whoever, who, through their own resources may monitor their own interests, the Investment Company Act poses an unnecessary impediment to their freedom to invest as they choose. In the same vein, enterprises in need of capital may be blocked from obvious and willing sources of capital by the limitation the act poses to capital formation through these vehicles.

The Investment Company Act generally requires that all securities investment pools register under the act and the registration imposes on these pools substantial requirements and restrictions. The private investment company exemption to the act, Section 3(c)(1) says that pools with fewer than 100 investors that do not make a public offering of their shares need not invest. It is this provision that allows funds managed by Tiger and others to avoid the strictures of the act. However, the limitation of ownership of such funds to 100 or fewer investors effectively excludes many sophisticated investors from participating in these funds. Managers in the greatest demand, like my client, those with the best records, find themselves having to turn away investors and maintain waiting lists.

H.R. 1495, with certain modest but critical modifications, would cure this problem. Proposed new section 3(c)(7) would exempt from the act funds sold only to qualified purchasers without placing any limit on the number of qualified purchasers that may participate in the fund. In theory, Section 3(c)(7) would give a sponsor of an existing private investment company two options. One, create a new 3(c)(7) fund in addition to an existing 3(c)(1) fund or, two, take an existing 3(c)(1) fund and convert it into a 3(c)(7) fund.

But in practice, right now, the statute as written would not work to that intended result without a couple of modifications. One would put to rest the question of whether a side-by-side 3(c)(1) and 3(c)(7) fund should be integrated for the proposes of determining the registration status of either. Over the years, the SEC has developed an integration doctrine to prevent sponsors of 3(c)(1) funds from skirting the act by creating cloned funds of 100 or fewer investors. If these funds are managed in essentially the same way, the SEC integrates them. That is, it puts them together which then causes the shareholder number to exceed 100 investors.

The integration doctrine, of course, has not been applied to 3(c)(1), 3(c)(7) funds because up until now there haven't been any 3(c)(7) funds. However, a sponsor of an existing 3(c)(1) fund who wanted to create a sophisticated qualified investor fund would, perhaps, find this limitation to be constrained.

The second modification would be to impose a grandfather clause on these amendments to assure that an existing 3(c)(1) sponsor

that wanted to convert that fund to a 3(c)(7) fund would not have to evict the existing shareholders from that fund. These are people who have developed loyalty to the fund and to the manager; they oughtn't to be thrown out simply because the manager would like to take advantage of this new legislation.

Just briefly, we also would recommend that the number that defines qualified individuals be lowered from 10 million to 5 million. Senator Dirksen said once, to paraphrase him, a million here—I think he said a billion, actually—but a million here, a million there and pretty soon you are talking about real money. $5 million seems like a lot of money to me, in any event.

Second, I understand from your counsel that I have a few extra minutes to briefly mention some issues for the Managed Futures Association. Should I do that now or should I come back to that? I will be guided by——

Mr. FIELDS. Could you come back to it? Let's go to our last person testifying and we will ask a question and give you an opportunity to explain that position.

Ms. SMYTHE. Thank you, sir.

[The prepared statement of Marianne Smythe follows:]

PREPARED STATEMENT OF MARIANNE SMYTHE, WILMER, CUTLER & PICKERING

INTRODUCTION

My name is Marianne Smythe, and I am a Partner at the law firm of Wilmer, Cutler & Pickering in Washington, D.C. I specialize in legal issues affecting the investment management industry. Before joining the firm in May of 1993, I served as Director of the Division of Investment Management of the U.S. Securities and Exchange Commission ("SEC"). Among other things, the Division of Investment Management is responsible for regulating investment companies and their advisers. In 1990, I served as Executive Assistant to former SEC Chairman Richard C. Breeden.

Mr. Chairman, you and this Subcommittee deserve enormous credit for introducing legislation—the proposed Investment Company Act Amendments of 1995—that sweeps cobwebs off the 55 year-old Investment Company Act of 1940. There are many features of the legislation that deserve commendation. I have been asked to testify concerning just one: the proposed amendments that would apply to private investment companies. My firm represents Tiger Management Corporation ("TMC"), a registered investment adviser. TMC strongly supports those amendments which would free investment companies that are open exclusively to qualified investors from unnecessary regulation.

No one may dispute seriously that the Investment Company Act of 1940, through the years, has offered substantial protections to investors. Likewise, there should be no doubt about the continued efficacy and validity of that law for the overwhelming majority of investors. However, for investors who have sufficient resources to monitor their own interests, the Investment Company Act poses an unnecessary and inappropriate restraint on their investment freedom. In the same vein, enterprises in need of capital may be blocked from obvious and wiling sources of capital by the limitations the Act poses to capital formation through private investment companies.

Below, we describe the benefits to the U.S. economy of the private investment company industry and the potential benefits to be derived from allowing further, modest growth in that industry. Next, we describe how the Investment Company Act of 1940 has tended to thwart and distort the development of private investment pools and why the Act's present exception for private investment companies, section 3(c)(1), has not been sufficient to address the problem. We then discuss how the provision in H.R. 1495, authorizing and expanding the scope of private investment companies, would alter the present regulatory picture and how that section, as now drafted, would interplay with the private investment company provision (section 3(c)(1)) already in the Act. Finally, we urge a few modest but critical modifications of H.R. 1495's private investment company provision without which it will not accomplish the beneficial effects for which it is intended.

PRIVATE INVESTMENT COMPANIES

Private investment companies (*i.e.*, those that have developed below the level that triggers registration under the Investment Company Act) defy easy description or categorization. The term "hedge fund" is often used to describe the larger of these types of pools, but that term is a misnomer: In addition to long and short positions or listed stocks, private investment companies also invest in commodity futures and option contracts; mortgages and mortgage-related securities; fixed-income securities generally; foreign exchange instruments; repurchase agreements; swaps and forwards; options; warrants; and securities sold in initial public offerings.[1] Indeed, a large and growing segment of the private investment company industry is composed of venture capital funds which provide needed capital directly to start-up companies or businesses seeking to expand their operations. These types of funds typically do not sell short at all.

Private investment companies also have a wide range of investment styles from the very speculative to the highly conservative. The Tiger investment partnership, for example, one of the funds managed by TMC, has approximately $1.7 billion in equity capital. TMC's management style may be described as conservative; it is not a "market timer," that is, it does not make big bets on the direction of the market. Rather, its experience is in identifying and picking individual stocks that it believes will significantly outperform the market over the long run. TMC's analysts/portfolio manager work together to create a fundamental investment approach that stresses diversification to minimize risk, rigorous research and analysis, strict adherence to investment discipline, and early identification of trends. Other private investment companies may be more or less aggressive in their approach: For example, there are growth-oriented funds, convertible arbitrage and multiple arbitrage funds, funds that invest in distressed securities, funds that invest in minority private equity positions, value funds, opportunistic funds, funds that are event-driven or that strive to be market-neutral, leveraged bond funds, international funds, macro funds, and emerging markets funds.[2]

Estimates of the total number and size of private investment partnerships also vary greatly, from 800-1000 funds with aggregate capital of between $75-100 billion to 3000 funds with assets exceeding $160 billion.[3] Venture capital funds, which are the most commonly and accurately tracked private investment companies, invested more than $4.2 billion in 1994,[4] and provided $1 billion of fresh capital in the first half of 1995 alone.[5] While these figures are impressive, they only hint at the potential capital that could be generated were it not for the current limitations on the number of investors that may participate in private investment companies.

THE INVESTMENT COMPANY ACT AND PRIVATE INVESTMENT COMPANIES

A. Regulation of Investment Companies

Section 3 of the Investment Company Act generally requires that all securities investment pools formed in the United States (including private investment companies) register as investment companies with the SEC. Registration under section 3 subjects the investment company to a stringent set of requirements and restrictions designed to protect investors against various types of risk and abuse, including those that stem from leverage, self dealing, and misuse of company assets. For example, section 17 of the Investment Company Act prohibits the manager of a fund from selling securities which it owns to the fund; section 22 requires that investment companies stand ready to redeem their shares at all times; section 18 limits

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[1] *See, e.g.*, Testimony of Barbara P. Holum, Acting Chairman of the Commodity Futures Trading Commission, before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives (April 14, 1994); Testimony of Arthur Levitt, Chairman of the U.S. Securities and Exchange Commission before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives (April 13, 1994).

[2] *See, e.g.*, Chief Executive, *Hedging for Dollars*, No. 98 at 68 (October 1994); Business Week, "Fall Guys?" 116, 119 (April 25, 1994).

[3] *See id.*

[4] Biotech Financial Reports, *Venture Capital Invested Over $1.3 Billion in Fourth Quarter of 1994*, Vol. 2, No. 3 (March 1, 1995) (based on figures from Private Equity Analyst).

[5] *See* Biotech Equipment Update, *Venture Capitalists Invested Over 1 Billion in First Quarter of 1995, Coopers & Lybrand Survey Says*, Vol. 3, No. 7 (July 1, 1995). According to the same Coopers & Lybrand venture capital survey, private equity investments in the first half of 1995 were as follows (based on millions invested and the regions in which those funds were invested): California—883.3; New England 247.0; Metro New York—194.6; Baltimore/D.C.—176.2; Pennsylvania—161.9; Texas 152.4; Colorado—139.4; Carolinas—129.4; Minnesota 108.1; Washington—96.1; and Other—596.6, *See* Washington Technology, *Netplex Metro Business Outlook*, Vol. 10, No. 12 (Sept. 28, 1995).

the amount of leverage investment companies may employ; and section 10 prescribes, among other things, the composition of investment company boards of directors to assure a degree of independence from management.

While protective in purpose, these and other provisions of the investment Company Act interfere with the freedom of high-net-worth investors and their asset managers to structure private arrangements outside the parameters of the Act. For example, if a group of investors would welcome significant hands-on and financial involvement by a fund manager in the portfolio companies in which their fund invests, the Act will thwart their wishes. If a group expects and anticipates long "lock-up" periods for invested capital, during which time withdrawal or redemption is prohibited or very circumscribed, the Act will preclude such arrangements. If the group wishes to invest in companies for which mark-to-market valuation is not feasible, the Act will pose substantial obstacles to their wishes. In sum, provisions that for most investors are *safeguards* under the Act, designed to protect them from fraud and abuse, are for a small but important group of investors *straightjackets* that prevent them from investing in a manner of their own choosing. To put the matter another way, the Investment Company Act imposes unnecessary regulation on pooled vehicles whose owners have the sophistication (or the means to acquire it) to evaluate for themselves matters such as the level of management fees, governance provisions and redemption rights. As a consequence of these impediments, the Act may discourage participation by those with the most to offer, both in terms of assets and investment expertise. The proliferation of offshore private investment funds is but one effect of this problem.

B. Section 3(c)(1) of the Investment Company Act

Section 3(c)(1) of the Investment Company Act, also known as the "private investment company exception," exempts an investment pool from regulation under the Act provided that: (1) it has 100 or fewer investors; and (2) it does not make a public offering of its shares. The 100-investor limit and the public offering prohibition were designed by Congress in 1940 to ensure the private nature of unregistered pools. While the legislative history in this area is sparse, the 100-investor threshold was most probably intended to represent the outer limit of an investor base likely to be composed of persons with familial, social or business ties, so that investors would have a relationship beyond mere participation in the pool.[6]

Section 3(c)(1) is the provision that allows funds managed by TMC (and other similar private investment pools), to avoid the strictures of the Act and to engage in investment programs and strategies that are not available to registered funds. The arbitrary limitation of the ownership of such funds to 100 or fewer investors, however, keeps many eager and motivated investors from enjoying participation in these "3(c)(1) funds." It likewise causes fund managers and potential investors to spend countless hours and dollars analyzing ways to assure that the 100-investor limit has not been breached. The limitation effectively and arbitrarily excludes many sophisticated investors from investment opportunities. Managers in the greatest demand—those with the best track records—find themselves in the invidious position of having to turn away investors and maintain waiting lists. Enterprises that are in need of capital, and whose attributes are familiar to sophisticated fund managers, may be deprived of that capital because the managers must limit participation in their pools to 100 or fewer investors. As is often the case, overregulation tends to penalize success.

THE INVESTMENT COMPANY ACT AMENDMENTS OF 1995

H.R. 1495, with certain critical amendments, would effectively address and cure this problem.[7] It would add a new section 3(c)(7) to the Investment Company Act.

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[6] *See* Division of Investment Management, U.S. Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation*, 106 (May 1992).

[7] The proposed legislation is similar to legislation originally recommended to Congress by the SEC in 1992. In that year, the SEC's Division of Investment Management published a report in which it concluded that, "[f]or issuers whose securities are owned exclusively by sophisticated investors, the public offering prohibition and the 100-investor limit of section 3(c)(1) of the Investment Company Act are not supported by sufficient public policy concerns." *See* Division of Investment Management of the U.S. Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation*, 110-14 (May 1992). Almost concurrently, the SEC submitted legislation to Congress that, among other things, would have added a new section 3(c)(7) to the Investment Company Act that would have exempted from registration publicly offered pools with an unlimited number of investors, so long as all investors are "qualified purchasers." The proposed legislation would have given the SEC discretion to define the term "qualified purchaser" based on certain factors, such as the investor's net worth and investment experience.

The new provision would exclude from the definition of "investment company" under the Act those funds that are sold only to "qualified purchasers." As a consequence, the investment companies owned by such purchasers ("3(c)(7) funds") would be exempt from registration and most regulation under the Act. In its present form, H.R. 1495 would define a qualified purchaser as an institutional investor whose discretionary investment portfolio equals or exceeds $100 million, or an individual who has an investment portfolio of at least $10 million at the time of the purchase.

The proposed legislation would leave present section 3(c)(1) intact. Thus, a manager such as TMC that now operates a private investment company under section 3(c)(1) could *theoretically* continue to operate that company with 100 or fewer investors (including some that would not meet the definition of "qualified"), and start a new company under section 3(c)(7) open only to qualified investors. However, as discussed below, because of SEC staff interpretations regarding "integration" of unregistered investment companies, there may be some substantial regulatory peril to operating 3(c)(1) and 3(c)(7) pools side-by-side. If parallel operation raises uncertainties, the alternative for existing private (3(c)(1)) pool operators would be to convert those pools to qualified purchaser 3(c)(7) pools. To do that, however, current investors in these pools who do not meet the definition of "qualified" would have to be evicted—an unseemly and possibly untenable result.

Therefore, while TMC applauds the introduction of this legislation, we urge that the legislation be modified to avoid these unintended and counterproductive consequences. Without modification, we fear that sponsors of existing 3(c)(1) funds, such as TMC, may, in effect, be barred from using the new law, a result surely neither intended nor desired. We therefore recommend that proposed section 3(c)(7) be amended to include:

- a statutory safe harbor providing firm assurance that sponsors of existing 3(c)(1) funds can organize new 3(c)(7) funds without triggering "integration" of these funds; and
- a "grandfather clause" to permit the orderly conversion of funds that presently rely on section 3(c)(1) into 3(c)(7) funds.

A statutory safe harbor could provide, for example, that a private investment company formed in reliance on section 3(c)(7) would not be considered "integrated" with another private company formed by the same sponsor in reliance on 3(c)(1). A "grandfather clause" would allow existing investors to continue their participation in existing 3(c)(1) funds whenever those funds are converted into 3(c)(7) funds. This grandfather clause could provide, for example, that in addition to qualified purchasers, a private investment company also may be owned by 100 or fewer persons who are not qualified purchasers but who purchased the company's securities on or before December 31, 1995. Together, a statutory safe harbor and a grandfather clause would provide managers with optimum flexibility to retain existing investors and acquire new ones without compromising the remaining protections of the Act.

A. The Integration Problem and the Safe Harbor Cure

Over the years, to ensure that persons do not manipulate the 100-investor and public offering limitations of section 3(c)(1) and the similar limits imposed by the SEC staff under section 7(d) of the Investment Company Act,[8] the SEC has developed a doctrine pursuant to which two or more related issuers may be considered a single "integrated" entity. The staff typically requires integration if, in its view, a reasonable investor would not conclude that related entities offered materially dif-

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In 1992 and again in 1993 legislation similar to that proposed by the SEC twice passed the Senate. The measures, S. 2518 and S. 479, differed from the legislation proposed by the SEC by removing SEC discretion to define "qualified purchaser" and instead statutorily defining that term to mean an institution that owns or invests $100 million on a discretionary basis or an individual that has $10 million in securities investments. However, S. 2518 also would have granted the SEC authority to alter the definition of "qualified purchaser" through administrative rulemaking. In 1994 this Subcommittee introduced a bill, H.R. 4858, that would have amended the Senate bill in two important respect (1) to limit the exception in section 3(c)(7) to pools that invest at least 50% of their assets in "small businesses" as that term is defined by the Small Business Administration; and (2) to remove SEC discretion to redefine "qualified purchaser" through administrative rulemaking. Although H.R. 4858 was ordered to be reported out of the Energy and Commerce Committee, the report accompanying the bill was not released prior to adjournment and the full House did not take up the bill.

[8] Section 7(d) prohibits a foreign investment company from publicly offering its securities in the United States unless the SEC determines by order that the Investment Company Act's provisions can be enforced against the company. Although section 7(d) does not expressly refer to any numerical limit on the number of United States investors, the SEC staff has imposed a 100 United States investor limit through no-action and interpretive letters. *See Touche, Remnant & Company*, SEC No-Action Letter (Aug. 27, 1984)

ferent investment opportunities.[9] Accordingly, a 3(c)(1) fund typically will be integrated with other related funds that share similar objectives, portfolio investments, and risk/return characteristics.[10] Although the SEC sometimes grants no-action assurance for similar funds offered to distinct groups of investors, it has done so only when the operational or legal structures of a fund would result in materially different economic—particularly tax—consequences to investors.[11]

Accordingly, the sponsor of a 3(c)(1) fund cannot safely form a similar 3(c)(7) fund unless the new fund is structured so that it would have materially different economic or tax consequences. Such structuring is likely to require that the fund substantially modify or contort its investment objectives, practices, or economic performance—independent of whether such modifications or contortions serve the best interests of investors. A sponsor who failed to take such steps could be subject to the risk that the SEC, its staff, or a court would take the position that the companies were one integrated entity that could not rely on either section 3(c)(1) or section 3(c)(7) and that therefore the entities should have registered under the Investment Company Act. This would defeat the primary objective of the legislation—freeing funds with only high-net-worth investors from unnecessarily and, in this case, deleterious regulation as well as from regulatory uncertainty.

A safe harbor would permit sponsors of existing 3(c)(1) funds to form new 3(c)(7) funds without the risk of being held in violation of the registration requirements of the Investment Company Act solely by reason of the SEC staff's integration doctrine. Consistent with the purpose of the legislation, this safe harbor would permit the formation of new entities, composed solely of qualified purchasers, without requiring the artificial modification of proven investment methods or the disaffection of longstanding investors.

B. Use of a Grandfather Clause to Prevent Eviction of Existing Investors

Under current law, section 3(c)(1) has been the primary provision under which pools of sophisticated investors have been able to operate outside of the strictures of the Investment Company Act. Many of these pools have some participation by investors who, although financially secure, may not meet the new bright line test. It is for this limited category of investors—only those who already participate in an existing 3(c)(1) pool—that the grandfather clause is intended. A grandfather clause, to permit the orderly transition of pools currently owned by sophisticated investors that presently rely on section 3(c)(1). Without such a clause, existing pools would have to "evict" current owners who do not meet the bright line qualified purchaser test, or be precluded from accepting additional investors in reliance on section 3(c)(7). Such a result is unnecessary for investor protection, would be inequitable, and would impede the objectives of the legislation.

Current investors have formed longstanding relationships with sponsors of 3(c)(1) funds. These investors purchased their interests after receiving full disclosure about the unregistered status of their investments under the Investment Company Act. Fundamental fairness dictates that relationships formed before the adoption a such a test not be needlessly disrupted or severed.[12] Moreover, in some cases, a sponsor of a section 3(c)(1) fund may lack clear authority under the fund's governing documents to require the withdrawal of an investor except for specifically defined cause. For example, a governing agreement may permit the sponsor to require that an investor withdraw if necessary to comply with the limitations of section 3(c)(1) of the Investment Company Act, but may constrain the sponsor from requiring an investor to withdraw for other reasons (such as effecting a conversion of a 3(c)(1) fund into a 3(c)(7) fund). Even if the sponsor does have apparent authority to require that in-

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[9] *See, e.g., Welsh, Carson, Anderson & Stowe*, SEC No-Action Letter (June 18, 1993); *Meadow Lane Associates, L.P.*, SEC No-Action Letter (May 24, 1989); *Frontier Capital Management Company, Inc.*, SEC No-Action Letter (July 31, 1988); *Madison Park Investment Management, Inc.*, SEC No-Action Letter (Apr. 4, 1986); and *Oppenheimer Arbitrage Partners, L.P.*, SEC No-Action Letter (Dec. 26, 1985).

[10] *Pasadena Investment Trust*, SEC No-Action Letter (Jan. 22 1993) (summarizing the staffs prior no-action positions).

[11] *See, e.g., Id.; Shoreline Fund, L.P.*, SEC No-Action Letter (Apr. 11, 1994) (A foreign company relying on section 7(d) need not integrate its offering with a domestic company even though the entities have identical objectives and risk/return characteristics. Because United States tax law made the economic consequences of an investment in either entity very different for both domestic and foreign investors, a reasonable investor would not view the investments as economically equivalent.).

[12] Of course, if current 3(c)(1) funds convert into 3(c)(7) funds, existing investors who do not meet the definition of "qualified purchaser" should be entitled to full disclosure about the transformation of their fund into a 3(c)(7) fund and should be given the opportunity to withdraw their capital before any conversion.

vestors withdraw to permit such a conversion, the sponsor may expose itself to investor dissatisfaction and potential liability if it evicts owners against their wishes.

The modification we propose would grandfather only existing investors in the 3(c)(7) fund. *Every* new investor thereafter would have to meet the definition of qualified purchaser. When an investor covered by the grandfather clause left a 3(c)(7) fund, the fund could not use that investor's "slot" for an investor who was not a qualified purchaser. Of course, an existing 3(c)(1) fund that did not convert into a 3(c)(7) fund could continue to admit new investors who were not qualified purchasers—but such a fund would have to continue complying with the requirements of section 3(c)(1) for an exclusion from the definition of investment company.

C. Definition of "Qualified Purchaser"

Finally, we would redefine "qualified purchaser" to include individual investors with $5 million in securities investments (rather than $10 million as proposed in H.R. 1495). It seems clear that an individual with $5 million in securities investments alone (as opposed to $5 million total net worth) has a degree of financial stability sufficient to accept the greater risk that comes with greater opportunity. These persons should not arbitrarily be denied the ability to participate in a 3(c)(7) fund. Thus "qualified purchaser" would mean: (1) an institution that owns or invests $100 million on a discretionary basis; or (2) an individual that has $5 million in securities investments.

Proposed alternative language to implement the statutory safe harbor and the grandfather clause, and to decrease the individual net worth required for "qualified purchasers," is included as Appendix A to this testimony, and is marked to show changes from the current bill. If Congress or the SEC has additional concerns that need to be addressed, we would look forward to discussing them with a view toward making section 3(c)(7) workable for the very persons who are most likely to foster capital formation as a result of the new provision—sponsors of existing 3(c)(1) funds that currently are offered to sophisticated investors.

CONCLUSION

I thank the Subcommittee for offering me the opportunity to present my views and those of TMC here today on the "Investment Company Act Amendments of 1995." There is a great need for legislation that will free from unnecessary regulation those investment pools offered exclusively to qualified purchasers. Amending the Investment Company Act to create section 3(c)(7) would benefit the capital formation process in this country and permit qualified U.S. investors to avail themselves of greater investment opportunities. It is critical, however, that Congress provide a safe harbor to permit the creation of 3(c)(7) funds without the risk of integration with existing 3(c)(1) funds, and enact a limited grandfather clause to permit the transition of existing section 3(c)(1) funds into section 3(c)(7) funds. These modifications would remove regulatory uncertainty and avoid disrupting longstanding relationships between 3(c)(1) funds and their current investors who, after full disclosure, purchased interests in those funds. To increase participation in 3(c)(7) funds, we also recommend that the $10 million threshold in the definition of "qualified investor" be reduced to $5 million.

[Appendix A is retained in subcommittee files.]

Mr. FIELDS. Thank you.

Mr. Paul Haaga, Senior Vice President, Capital Research and Management Company.

STATEMENT OF PAUL G. HAAGA

Mr. HAAGA. Thank you, Mr. Chairman. I am very pleased to be here to testify before the subcommittee today. I might note that prior to joining Capital 10 years ago, I was in private practice representing a number of mutual funds including as separate counsel to independent directors and I began my career as a staff attorney with the Division of Investment Management of the Commission.

Our fund group consists of 28 funds sold through independent brokers and financial planners. We have about 7 million shareholder accounts and over $100 billion in assets. We are the only independent fund group that is participating in the profile prospectus test and we are testing it through the brokers.

We would like to again repeat our endorsement that we have made several times since 1992 of the staff's conclusion in their Protecting Investors study which is at the basic structure of the investment company regulation is sound and should not be changed lightly or in any dramatic way. At the same time, we recognize as the staff did in 1992 and as the staff and the subcommittee does now, that circumstances change and the act will remain healthy only if it receives periodic checkups so we commend this bipartisan effort and we also commend your including the SEC and the industry in that review.

In our view, the dramatic growth and wide acceptance by the American public of the mutual funds in recent years is a result of five factors. With a comprehensive substantive regulation of funds in the Investment Company Act, independent director oversight, the commitment of the industry to internal compliance, diligence of the SEC staff in inspecting and enforcing the act and the flexibility of the entire regulatory structure that has permitted the industry to continue to meet investor needs in a changing investor environment.

We submit that any proposed changes to the act should be evaluated against this background and with the first rule being to do no harm to a system that is working very well. The second test should be whether they would enhance any of the above principles and thereby increase the investor protection and the value of fund services that are so important as we receive more and more Americans who trust us with their money.

Let me briefly summarize our comments on certain provisions of H.R. 1495 and the matters that you asked about in the invitation letter and then I will look forward to responding to the committee's questions.

In the recordkeeping and reporting area, we would support the SEC's request that its ability to require reports and to inspect records be expanded with a couple of caveats. The first is that routine access to records and inspections should exclude written records of internal compliance, internal audit and risk management matters. Those records should continue to be available in a formal investigation pursuant to subpoena as they are now but we are concerned that their routine availability and inspection would have a chilling effect on the internal compliance process. Second, we would require in the statute a rigorous cross-benefit analysis before the SEC requires additional reports or records. And, last, we would limit the expansion of the reports to the SEC to portfolio sales and redemption activities in times of market stress and we understand that is basically what the SEC is looking for in that expanded reporting requirement.

In the corporate governance area, we support the requirement that independent directors select and nominate additional candidates. That is currently required of all funds with 12(b)(1) plans like ours. We have been living with it for 7 years and we find it works very well. I was glad to hear Barry's second answer to the question about involvement of the insiders in the selection and nomination process because we think that the subcommittee should clarify either in the statute or in the legislative history that there is no intention here to exclude insiders entirely from the process.

We think insiders should be allowed, certainly, to meet with candidates, express their views on candidates and even suggest some candidates, assuming that the ones suggested by the insiders are not the only available candidates.

We are pleased that the industry has overwhelmingly adopted the majority and even super majority independent board structure. We have no objection to the 60-day termination provision or the majority independent provision but we note with some pride that those are superfluous.

In the shareholder voting area, we would support the correction of what really amounts to a technical problem that frustrates the views of a majority of shareholders and just imposes a cost on shareholders.

Finally, even though the red light is on, let me say something quickly about, if I may, about Federal and state regulation. We think it is a crime in this era of limited regulatory resources that states and the Federal Government are doing the same thing. Basically the states are doing the things that the NASD and the SEC do so well. At best it is only a waste of money and a burden on the industry. At worst, it frustrates the SEC's efforts to develop a sound but flexible regulatory environment for an industry that is truly national in character.

Thank you.

[The prepared statement of Paul G. Haaga follows:]

PREPARED STATEMENT OF PAUL G. HAAGA, JR., SENIOR VICE PRESIDENT AND DIRECTOR, CAPITAL RESEARCH AND MANAGEMENT COMPANY

I. INTRODUCTION

I am Paul G. Haaga, Jr., a Director and Senior Vice President of Capital Research and Management Company (CRMC), a mutual fund management company headquartered in Los Angeles, California. I also serve as Chairman of the Board of the Fixed Income Funds managed by CRMC, and as President and a Director of Capital Income Builder and Capital World Growth & Income Fund. I commend the subcommittee for holding this hearing on H.R. 1495, the "Investment Company Act Amendments of 1995," and related matters and I am pleased to be here today to share my views and to respond to any questions that you may have. The bill recognizes that even with the success of the Investment Company Act of 1940 (the Act) as a statute, modernizing efforts are not only helpful but necessary as the industry moves into the next decade. Specifically, I would like to take the opportunity to address several matters in the bill that relate to the fundamental goal of securities regulation—investor protection. These are: (i) the internal compliance systems maintained by investment companies and their advisers; (ii) the investment company corporate governance process; and (iii) the federal and state regulatory structures with respect to investment companies.

II. DESCRIPTION OF CRMC AND THE AMERICAN FUNDS GROUP

CRMC is the sponsor and investment manager of the 28 mutual funds in The American Funds Group (The American Funds or the Funds). The Funds are sold through independent broker-dealers and financial planners in all fifty states and the District of Columbia. The American Funds currently have more than $100 billion in assets and over seven million shareholder accounts. The Capital organization also includes several other investment management affiliates that operate quite separately from CRMC and advise major pension plans and other institutions. The Capital organization is owned by its employees and traces its roots back more than 60 years.

CRMC and its affiliates employ more than 3,200 people, including more than 1,600 in four California offices. CRMC affiliates operate shareholder service centers employing substantial numbers of associates at other locations around the country—

including San Antonio, Texas (more than 500 employees), Hampton Roads, Virginia (more than 400 employees) and Indianapolis, Indiana (more than 250 employees).

III. COMPLIANCE AND RECORDKEEPING

The investment company industry has a strong tradition of taking preventative action to ensure compliance with existing laws, and of identifying and addressing potential problems quickly and effectively. This tradition has contributed to the strong investor confidence, and absence of significant abuse, that has characterized the industry. As Securities and Exchange Commission (SEC) Commissioner Steven Wallman recently pointed out:

> "the mutual fund business has been remarkably free from significant problems or scandals...in no insignificant part, it is largely due to [the efforts of fund directors] and the efforts of others in the fund industry... to work cooperatively with us to develop practical solutions to difficult problems faced by investors." [1]

Recently, we participated in a review of mutual fund internal compliance systems conducted by the Investment Company Institute. This study concluded that rigorous internal compliance procedures, in addition to those expressly required by statute or regulation, are widespread in the mutual fund industry and an integral part of the industry's culture. Such internal compliance efforts characteristically include documented policies and procedures regarding, among other things, compliance with investment objectives and restrictions, share pricing, transactions with affiliates, advertising, timely filing of materials with the SEC and states, and proper maintenance of books and records.

Like its peers throughout the mutual fund industry, CRMC maintains a thorough and comprehensive internal compliance program to ensure continuing adherence to the complex regulatory requirements governing our operations. In our view, effective compliance requires the attention and full support of senior management and the entire organization.

While all parts of our organization are involved in compliance, three departments within CRMC have particular responsibility in this area—Fund Administration and Compliance, Investment Administration and Fund Accounting—employing more than 120 persons in the aggregate. CRMC's compliance system is characterized by a multi-level structure, which allows potential problems to be identified at several points in the compliance process. As an illustration, under our portfolio compliance system, any equity trading order must be cleared before entry with personnel in the Investment Administration area; these persons effectively act as gatekeepers, ensuring that potential purchases are consistent with each Fund's investment restrictions. Trades are then rechecked at two subsequent levels to ensure that, even if an error were not detected initially, it could still be identified after the fact, in many cases before a purchase had settled and an inappropriate security had appeared in the Fund's portfolio.

Of course no compliance system can guarantee error-free operations in such a complex and highly regulated business. And while our system is well suited to CRMC's method of operating, we recognize that there are many ways to structure an internal compliance system and that ours does not represent the only model; rather, we believe that fund complexes and advisers should be encouraged to tailor their compliance programs to meet their unique organizational and operating structures.

In our view, one important standard by which to judge any action taken by Congress in this area is whether it serves to bolster industry compliance practices. By the same token, Congress should avoid the enactment of laws that, even inadvertently, could operate to undermine industry compliance efforts. In this regard, we believe that one provision in H.R. 1495 adds little if anything to the SEC's regulatory program but could have a very negative impact on compliance efforts at our firm and other investment company complexes. That is the provision that would allow the SEC staff to obtain access at any time in routine inspections to *any* investment company records, including confidential records relating to internal compliance. We believe that if all confidential documents were made available to the SEC staff in routine inspections, it could inhibit the willingness of supervisory and compliance personnel to communicate candidly and to document their internal perceptions of potential problems. In my experience, such communication and documentation are critical components of an effective internal compliance system.

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[1] Commissioner Steven Wallman, Remarks at the Investment Company Institute's 1995 Investment Company Directors Conference & New Directors Workshop (September 22, 1995).

The SEC staff has ample authority to obtain all relevant non-privileged documents whenever it has gone through the steps of requesting investigative authority from the SEC and, where appropriate, enforcement of a subpoena. We believe that these steps provide important protections for registrants without in any way inhibiting the SEC's inspection and enforcement programs. In sum, the additional authority that the SEC would have under the proposed bill is not necessary, but the exercise of that authority clearly could undercut the effectiveness of internal compliance programs as a first line of defense for protection of shareholder interests.

H.R. 1495 also would significantly expand the SEC's current authority by allowing it virtual carte blanche to require investment companies to file any information with it, and/or to include such information in shareholder reports. We urge that the subcommittee carefully consider the need for such a broad grant of discretion to the SEC and suggest that it might be more prudent to limit such a requirement to data that is actually shown to be required by the SEC (or by fund shareholders) but not currently available to them. Here, too, we are not aware that the current statute has posed particular difficulties for the SEC in carrying out its regulatory responsibilities. A more precise delineation of the SEC's authority to require such reports, perhaps tailored to address the SEC's need for special information in periods of market crisis, would serve the SEC's needs without potentially adding burdensome reporting and filing requirements that lack corresponding benefits to fund shareholders. Consistent with the bill's approach to maintain investor protection in a cost-effective manner, we believe that the SEC should be directed to analyze carefully the relative costs and benefits of any new reporting requirements for investment companies.

IV. CORPORATE GOVERNANCE

As a member of the board of directors of certain of The American Funds for the past 8 years, and having worked with fund boards for nearly 20 years, I am pleased to have an opportunity to share with the subcommittee my views regarding corporate governance issues affecting investment companies. Specifically, I would like to address: the responsibilities of investment company directors in general and the structure and operation of The American Funds' boards; certain matters relating to the nomination and role of the independent directors of a mutual fund; and the various revisions proposed in H.R. 1495 with respect to the voting rights of investment company shareholders.

In many respects, the Act establishes a federal corporate law for investment companies. The Act requires a fund to have a board of directors, forty percent of whom must be independent of management, and vests the directors with responsibility for overseeing the operations of the company and policing conflicts of interest. Moreover, the Act grants fund shareholders the right to vote on certain matters that are fundamental to the company's operations, such as the election of directors and approval of fee arrangements and any changes in fundamental investment policies.

The Act also gives investment company directors numerous specific responsibilities, including considering contracts with the fund's service providers, pricing the company's shares, valuing portfolio securities that are not readily marketable, and attending to such corporate matters as issuance of securities, declaration of dividends, election of officers and appointment of committees of the board. Many board functions are carried out through audit, nominating and other committees. Investment company directors also have responsibility for calling shareholder meetings, adopting and amending corporate by-laws, as appropriate, and, in conjunction with shareholders, considering extraordinary transactions facing the company, such as mergers. Independent directors have a special role designed to address the unique potential conflicts of interest inherent in the investment company structure. Specifically, these directors are required to vote separately, as well as together with the full board, with respect to such matters as approval of investment advisory and underwriting arrangements and contracts with other affiliated service providers.

Each fund in The American Funds Group has its own board, and the boards are organized in clusters that meet together; the number of funds in each cluster varies from one to ten. This structure evolved historically as CRMC organized funds and also acquired the management relationship with several other fund groups over the years. We find that this system works well for us.

The American Funds boards meet at least quarterly, and often as many as five or six times a year; committees typically meet once or twice a year, both in conjunction with, and between, meetings of the full board. The audit, contracts and nominating committees are composed entirely of independent directors and are responsible, respectively, for selecting and overseeing the relationship with the fund's independent accountants, performing a detailed annual review of the fund's distribution

(rule 12b-1) plan and contracts with its service providers, and selecting and nominating new independent directors to the board. Recently, several of tl.e funds have instituted proxy committees to cast the fund's votes with respect to its portfolio securities.

Over the years, SEC regulation has increasingly imposed detailed operational responsibilities on fund directors—duties that can in some instances serve to detract from the overall roles of the board and of its independent directors. In this regard, we are encouraged that Chairman Levitt has stated that the SEC plans to undertake a comprehensive review of its rules under the Act. Moreover, certain steps taken by the SEC and its staff during the past two years, including the recent proposal to reduce the specific responsibilities placed on investment company boards in connection with custody of portfolio securities outside the United States, represent a positive movement.[2] In its current form, rule 17f-5 under the Act requires fund boards to make detailed findings in an area (non-U.S. custody) that is outside most directors' fields of experience and expertise. The proposed amendment would require the boards to remain informed regarding these custody relationships but would enable them to shift the burden of making detailed findings to the fund's adviser or another responsible entity.

In our experience, directors significantly influence the operations of funds and their service providers, including the development of any fee or other proposals that ultimately will come before them for a vote. Unfortunately, some critics of the fund industry in the press and elsewhere would judge the boards' contributions solely by looking at the number of management proposals that are rejected or contracts that are terminated, rather than by the valuable input regularly provided by directors in their oversight roles and in the development and negotiation of proposals.

1. Independent Directors

The pending legislation raises three issues that affect fund boards of directors. The first concerns the process by which new independent directors are elected to fund boards. Rule 12b-1 under the Act mandates that all funds that have adopted a distribution plan under that rule commit the selection and nomination of independent directors to the discretion of the sitting independent board members, and we support the provisions in the bill that would require all funds to follow this practice. Nonetheless, while we agree that the formal selection process should be entrusted to the independent directors, the legislation should make it clear that all members of the board, including those who are interested persons of the fund, may be involved in the informal, collegial process of identifying candidates. This process may include meeting with potential directors, considering their backgrounds and assessing their suitability in light of the board's needs. We believe this would comport with current industry practice under rule 12b-1; moreover, to exclude certain directors from the process could undermine the board's cohesiveness and represent a disservice to fund shareholders.

The bill also proposes that a majority (rather than 40 percent) of an investment company's board be composed of independent directors. Funds with rule 12b-1 plans as well as funds with managers who have recently experienced a change of control currently must have a majority of independent directors, and Investment Company Institute data indicate that nearly all other funds also have a majority of independent directors. Accordingly, while CRMC supports majority independent boards, both in principle and in its practice, we note that in light of industry practice, the proposed statutory revisions would be largely superfluous.

Under current law, continuance of fund advisory contracts must be approved each year by a majority vote of both the entire board and the independent directors voting separately, and a majority of the entire board can terminate the advisory contract at any time upon 60 days' notice to the adviser. The bill would extend to a majority of the independent directors acting separately the 60-day termination authority. Again, as in the case of the provisions concerning board composition, this new termination authority would have little practical effect. Because independent directors already are a majority (usually a super-majority) of most boards, they are able to terminate an advisory contract in 60 days under the current provision. Even if they could not do so, the lead time required to identify a new manager makes the independent directors' authority not to renew at the end of the contract year sufficient for all practical purposes.

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[2] *See* Investment Company Act Release No. 21259, *Custody of Investment Company Assets Outside of the United States*, July 27, 1995.

2. Shareholder Voting

As noted above, the Act vests fund shareholders with the right to vote on, among other things, election of directors, approval or disapproval of fee arrangements, and changes in fundamental investment policies. H.R. 1495 would change the current definition of a majority vote, for purposes of these provisions, to require the vote of a majority of the shares present at a meeting at which a quorum is present and voting on such matter. We strongly support this amendment as it would rationalize investment company shareholder voting requirements and facilitate the voting process.

It is often difficult for funds to obtain a sufficient shareholder response to their proxy proposals to satisfy current Act voting standards. As a result, funds must often hire solicitation firms to call shareholders, at significant expense, and in some instances, multiple resolicitations are required. Moreover, the current voting provisions have the effect of counting a shareholder's failure to express opinion on a proposal (*e.g.*, by abstaining, or, in the case of a street name account, even failing to return the proxy) as a vote against a matter.[3] Thus, even where shareholders who respond vote overwhelmingly in favor a proposal may fail.

The revised Act standard as proposed in H.R. 1495 seeks to resolve this problem by allowing funds to count as present only those votes actually cast on a particular matter. Thus, where brokers are required to abstain from voting street name shares on non-routine proposals, the shares would be treated as being absent, allowing a proposal to pass if a quorum were obtained and a majority of those votes *actually cast* were voted in favor of the proposal.[4]

In addition to the revised methods of counting shareholder votes, H.R. 1495 would make certain substantive and important changes to the voting rights of mutual fund shareholders. We support the provisions that would specifically vest fund shareholders with the right to vote on any proposed changes to a fund's stated, fundamental investment objective. This right, which is consistent with current industry practice, is important because a fund's investment objective is one of its most basic defining attributes, and as such should not be altered without shareholder approval.

We also support the provisions in H.R. 1495 that would eliminate current voting requirements with respect to ratification of investment company auditors and initial approval of advisory contracts. It is widely recognized that in each of these cases, the voting requirements are formalistic and serve no particular purpose. Selection of auditors is a matter more appropriately left to the board of directors. The approval of initial contracts is unnecessary because fund sponsors typically supply the seed money to the fund and approve the contract and, in any case, the initial public shareholders have effectively voted on the contractual arrangements by making their investments.

V. PROMOTING INVESTOR PROTECTION THROUGH COST-EFFECTIVE FEDERAL/STATE INVESTMENT COMPANY REGULATION

We strongly support the stated goal of H.R. 1495 "to provide more effective and less burdensome regulation,"[5] to the extent that this can be achieved consistent with investor protection. It is well known that the operating resources provided to the SEC have not kept pace with the explosive growth of the mutual fund and investment advisory industries. We urge Congress to approve the SEC's request for additional funding; at the same time we strongly urge that the federal and state regulatory schemes be tailored to make greatest use of the limited resources of the various regulators in a manner that will best promote investor protection.

State registration can prove to be a significant impediment to the distribution of fund shares without any offsetting investor protection benefits. This is due largely to state disclosure requirements that often duplicate or conflict with each other and with SEC-mandated disclosures, as well as limitations on fund portfolio investments and other restrictions that can vary greatly among the states and from federal law.

[3] For fund shares held in broker "street name," proxy materials are sent to the shareholder's broker. Under current New York Stock Exchange rules and related laws, the broker is authorized to vote the investor's shares on "routine matters," but must abstain on any "non-routine" matters, in the absence of instructions from the investor. The broker's vote in favor of the routine proposal causes the shareholder to be counted as present at the meeting as to all matters, but the abstention on non-routine matters operates in practice as a vote against these proposals even though the shareholder expressed no opinion and in fact did not even return the broker's request for instructions.

[4] We recommend that certain minor clarifications be made to the language of this bill in this regard to ensure that it accomplishes its intended goal. Specifically, the words "voting on such matter" should be moved to follow the reference to "majority of the shares" in the text.

[5] H.R. 1495, 104th Cong., 1st Sess. (1995).

Like most large fund groups, The American Funds (with the exception of three single-state municipal bond funds) are qualified in all fifty states and the District of Columbia. One consequence of such nationwide sales is that each investment limitation imposed on the funds by a single jurisdiction dictates the investment opportunities available to shareholders across the country.

Duplicative state review of fund registration statements almost always produces a more complex, and often confusing, prospectus due to the need to expand and often duplicate disclosure to accommodate individual state comments. In addition, funds may be delayed in offering their shares on a timely basis due to conflicting disclosure demands from state securities regulators, which often are made after the fund's registration has been reviewed and declared effective by the SEC staff. Moreover, as a result of this process, fund shareholders ultimately bear needless additional expenses, such as legal and printing fees resulting from the need to address these often conflicting and duplicative disclosure and other requirements imposed by the various states. We believe that investor protection would not be jeopardized, but actually would be enhanced, if the SEC were given exclusive authority over disclosure and substantive regulation for investment companies and the states were required to concentrate on preventing and detecting fraud. In support of these functions, the states should be permitted to continue to require notice filings, consent to service of process and payment of fees.

VI. ADDITIONAL PROVISIONS OF H.R. 1495

I understand that my fellow panelists will be commenting in response to the subcommittee's questions on the unified fee investment company and the advertising prospectus as proposed in H.R. 1495. Nonetheless, I would like to respond briefly to the subcommittee's request for our views on these subjects.

1. Unified Fee Fund

Although it is unlikely that our organization would offer a unified fee fund as contemplated in the legislation, we do not oppose the concept in principle. We would, however, oppose any provision that limited the availability of the unified fee structure to funds that do not impose sales charges on investors. As stated above, our funds are distributed through brokers. Our funds' distribution costs are financed in part through up-front sales charges paid by investors and in-part through ongoing rule 12b-1 plan expenses borne by the funds themselves and therefore by all shareholders. We believe that this sharing appropriately reflects the fact that the benefits of the distribution process are shared between the new investor receiving the personal services of a broker and the existing shareholders who benefit from asset stability and growth. If the unified fee fund structure were not available to funds imposing a sales charge, it would be limited to those funds that had determined that the costs of distribution should be borne entirely by the existing shareholders and not at all by new investors.

We understand that there are two concerns with sales charges for this purpose. The first is that the sales charge would be an additional expense calculated in a different manner from the single unified fee and therefore might be difficult for an investor to understand. The second concern is that the sales charge might affect the investor's flexibility in determining whether to leave the fund in response to an announced fee increase. Neither concern is valid. First, the sales charge is deducted immediately from the shareholder's account at the time of purchase so it is actually more straightforward, visible and easily understood than are those expenses paid by the fund. Second, over time taxable shareholders are much more likely to be "locked in" by the potential capital gains taxes imposed on a redemption than by the fact that a sales charge was paid.

Consistent with our previous observations about the important role of fund directors, we believe that unified fee fund directors should retain a substantial oversight role with respect to potential conflicts of interest as well as the services provided to the fund by the investment adviser and others.

2. Advertising Prospectus

Because we do not sell shares directly to the public, our organization likely would not benefit as much from the availability of an advertising prospectus as would the direct marketed funds. Nonetheless, we strongly support the elimination of the present requirement that mutual fund advertisements be limited to information "the substance of which" is contained in the statutory prospectus. Elimination of this requirement would not reduce investor protection because the advertisements would remain subject to the prospectus liability standards. It would, however, provide funds with greater flexibility to furnish concise, useful and important information to shareholders. This will be increasingly important as the 401(k) plan marketplace

expands and employees who are inexperienced in investing require education regarding as many as dozens of potential investment options. In a related matter, we are one of the eight fund groups currently participating in the SEC's "fund profile" project. We believe that the proposed advertising prospectus will provide similar benefits in enhancing investor education.

Finally, I want to thank the subcommittee for the opportunity to participate in its consideration of H.R. 1495, and to commend your moving on legislation that will permit the industry to provide better investment services to its shareholders. We would be pleased to provide any additional information to the subcommittee in connection with these important matters.

Mr. FIELDS. Thank you, Mr. Haaga.

The Chair will recognize himself for a line of questions.

First of all, Mr. Powell, you and Mr. Riepe talked about the profile prospectus, the reform that has been initiated by Chairman Levitt.

I want to make sure I understand your testimony. You are not requesting or suggesting that that profile prospectus be made a part of our legislation, are you?

Mr. RIEPE. No, sir, no. We are not. What we are suggesting is that that prospectus is one of the examples of the SEC's work with the industry to develop a better form of information for the industry and for investors.

Mr. FIELDS. Is it both of your testimony that this is an example of how less is really more?

Mr. POWELL. Exactly. I think it is a wonderful document in terms of making it simple for an investor to understand just what he is investing in. It does away with the legalese, it does away with the document this thick that most people don't even read or understand.

Mr. FIELDS. I think that you testified that it actually is easier to understand and it is easier to compare. That there is actually a dual investor benefit from that.

OK, Mr. Powell, let me ask you to go a little bit further in your statement regarding electronic prospectus. How would you see this working?

Mr. POWELL. I believe most mutual fund companies are probably going to have a page on the Internet that would explain in many ways things very similar to what the profile prospectus would explain. The only difference would be that a prospective shareholder or investor would have access to that information electronically as opposed to via paper.

Mr. FIELDS. Is it your anticipation that that might be or could it be interactive where someone can ask specific questions that would get a response at your fund?

Mr. POWELL. It is conceivable. Either that or you could have frequently asked question kind of format.

Mr. RIEPE. Excuse me, Mr. Chairman.

One of the problems that I think we highlighted in our testimony is that as we move into this electronic era is that it is even more complex if in fact, in addition to the SEC and the NASD we have to deal with 50 additional regulators in trying to resolve what is the best way to communicate this information to prospective investors.

Mr. FIELDS. Let me ask, does that play into what you testified to, Mr. Riepe, just earlier that about international competitiveness?

Does this legislation, in and of itself, enhance international competitiveness or should we do some other things?

Mr. RIEPE. I think it holds the potential to do that and the one particular aspect that I alluded to was the unified fee investment company because, outside of the U.S. the corporate structure that investment companies have adopted in this country is not used. Something much closer to the UFIC structure is used outside of the U.S. So, to the extent we want to export our investment knowledge and our investment services to other countries, if we could export it in a form that looks much more like the form that is typical in those countries, I think it will absolutely enhance our competitiveness.

Mr. FIELDS. Mr. Haaga, my time is about to run out but let me ask you, you talked about the routine availability of certain information being made available to the SEC could actually chill—and I lost your comment. Could chill what?

Mr. HAAGA. Could chill the internal compliance process. Right now, if memos are written between people in the—internal people in the company relating to compliance problems, those would not routinely be available to the SEC staff when they came in for an inspection. They would only be available if they had a formal order of investigation and we think that that, at least, would build in some protections where the SEC staff would have to, for example, go before the Commission to show that there was a—show some cause and show that there was a need for the records.

Mr. FIELDS. So are you suggesting that our legislation goes too far in that particular regard?

Mr. HAAGA. It goes too far and I would say just cut it back in that limited area.

Mr. FIELDS. How would a cost/benefit analysis be done by the SEC, because you mentioned that also as part of your proffer.

Mr. HAAGA. I think that the Commission would be, in doing a cost/benefit analysis, would essentially go beyond what it does in a normal administrative procedure act rulemaking proceeding and actually require some economic analysis of the benefit and take a formal survey of the costs to particularly small investment companies producing those records.

Mr. FIELDS. Thank you. There will be two rounds of questions. Let me recognize my good friend from Massachusetts, Mr. Markey, the Ranking Minority Member, and also say I don't think we would be sitting here today if it were not for the work that he did in an oversight capacity last term and his cooperation in developing this particular piece of legislation.

Mr. MARKEY. I thank the Chairman very much.

Mr. Riepe, if I could, I would like to ask you briefly about the issue of state review of mutual fund prospectuses. Is it your view that what is needed is a reallocation of responsibilities between the Federal and state regulators, that state regulators should focus on their strengths, which Mr. Fink suggests are preventing and, when necessary, prosecuting local state's practice abuses and fraudulent activity and leaving to the Federal Government then the activities which they have been performing as well?

If you could, it would be helpful for us so that you can explain to us how you think that that might enhance rather than diminish the protection for investors.

Mr. RIEPE. Yes, Congressman. The states like all government bodies right now have very limited resources, in spite of the tens of millions of dollars that we provide to them in fees paid each year. They are far better suited to monitor things like sales practices and fraud and such abuses, monitoring some 20,000 investment advisors that can be one person shops scattered around the country.

Their resources are far better used focused in on that and allowing the central, national, Federal bodies like the SEC and the NASD to have sole responsibility for things like registration statements, offering circulars, advertising materials, et cetera, so there can be one national standard for those and I think what we have now is this duplication which is very costly to the industry, very costly to fund shareholders because they pay many of these costs through the mutual fund themselves and we have, perhaps, contradictions in the way that these areas are enforced and I think they would be solved by reallocation.

Mr. MARKEY. Mr. Fink, can you address that same question as well?

Mr. FINK. Yes. I think in Washington we have a 400-person Division of Investment Management whose expert on fund disclosure and Chairman Levitt developing a profile and on investment limitations set forth in the Investment Company Act and they police and monitor and set those standards. That is where their national expertise lies.

As I said in my oral, the fund industry sells in all 50 states, we are a national industry. We have become increasingly national through technology. Maybe at one time, funds had geographic homes, but that is no longer true. So the SEC and the NASD in the case of advertising set national standards. Where they are not experts is in what is going on around the corner. What about, as Mr. Riepe said, the one-man advisor over a garage. That is where you need a local policeman and that is where the states excel.

The trouble is now that a lot of states, instead of spending their time policing those kind of things, are duplicating reviews and prospectuses in advertising and setting their own investment limitations. It is duplicative, it is costly, it does not make any sense. It is getting worse.

I think the popularity of mutual funds has drawn states who used to be inactive into feeling that they should second guess the SEC. More funds are selling nationally and using Internet and other technology to sell. So it is getting worse, not better. And meanwhile, ironically, as Mr. Riepe said, resources at both the Federal and state governmental levels are less than ever and it really is a time to reallocate and I think Chairman Levitt spelled it out last week as well as I could.

Mr. MARKEY. As you all know, this is a very sensitive subject that we are discussing right now and we have to be careful in terms of how we strike the balance but I am looking forward to working with the Chairman on this issue so that we can strike a

proper balance and I think it is something that we should be looking at.

Now, Mr. Fink, in your testimony you say, and I quote, the most important factor contributing to the mutual fund's growth is the stringent regulation imposed by the Investment Company Act of 1940. Now, I reviewed that statement several times and I looked back to make sure that the punctuation was correct and perhaps there wasn't a comma and it went on but that was it, it was over, there was a period at the end of that sentence. The stringent regulation was the key factor in assuring for the growth of the industry, which seems to be a paradox to some extent when viewed by other industries.

In light of your industry's success in this existing regulatory framework, what are your thoughts about the SEC's 10 percent cutback?

Mr. FINK. I would hope it was not cut back. I can't—not working there, I can't tell you the right dollar amount but I would not just across the board cut back the SEC. A, it is needed for investor protection and, B, ironically, the SEC brings in a lot more in fees than it gets given by Treasury.

So we recently submitted letters to the committees in the Congress saying the SEC at least ought to get what it got last year.

Mr. MARKEY. And what about the office that helps to make the American investors more self-reliant that is already built into the SEC?

Mr. FINK. The investor education?

Mr. MARKEY. Yes.

Mr. FINK. I am not really an expert on the inner workings of the SEC. I guess my main interest, and not to belittle that agency which I duck because I don't really know much about, is really investment management which does direct mutual fund regulation. That is where I am most concerned.

Mr. MARKEY. With the indulgence of the Chair, Ms. Smythe, could you just deal with that for a second?

Ms. SMYTHE. I am speaking, of course, now in my personal capacity because I am no longer at the SEC and this is not a Tiger issue.

I think across-the-board cutbacks are always questionable because they knock off valuable as well as perhaps unnecessary functions. I think the consumer protection efforts of the SEC, the investor education efforts of the SEC are very important.

Mr. MARKEY. Could you just explain briefly how the Commission right now monitors compliance with the 99 investor limit? Could you give us——

Ms. SMYTHE. Well, I can explain how they monitored it 2½ years ago and maybe things have changed by now but the monitoring of compliance with the 100 investor limit is essentially done through, if anything, examination of investment advisors because the—if the entity is not registered with the SEC, there is no real inspection program to identify it.

There was a question before about what happens if somebody dies and there are more than, you know, there is more than one legatee and could that knock the number over 100? I was sort of smiling to myself and thinking that the SEC just does not have a sort of a laser beam detector in every one of these funds to figure

out when it goes over 100. I imagine there are quite a number. I whispered to one of my friends, what happens if somebody has triplets.

I mean, there are clearly going to be times when the number goes over 100 and the SEC is not going to know about it and probably not care, as long as it is the kind of fund that was created in the first place by associations of a family or community nature.

Mr. MARKEY. Thank you, Ms. Smythe.

Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Oklahoma, Mr. Coburn.

Mr. COBURN. Mr. Chairman, let me pass at this time if I may.

Mr. FIELDS. The gentleman needs to be informed that if he passes, then——

Mr. COBURN. I may not be back.

Mr. FIELDS. OK, the gentleman from Washington State, Mr. White.

Mr. WHITE. Thank you, Mr. Chairman, I just have a couple of questions and really they are questions probably for any member of the panel.

We talked a little bit about the restrictions that—or the duplication or potential duplication that the state regulation of some of these funds has. Could you give us some concrete examples of exactly how those work? I recognize the concept of duplication in general implies some restrictions but are there more specific problems that you are running into that you could tell us about?

Mr. HAAGA. I'll start with an example. Several years ago the SEC adopted Rule 144(a), which relates to resales of technically restricted securities in the institutional market. The staff then developed rules about how subject to independent and full board of director review, mutual funds could make determinations as to whether 144(a) securities were liquid or illiquid for purposes of the limits on illiquid securities in open-end investment companies.

We carefully reviewed those rules, participated in their development and then spent a lot of time internally adopting such procedures and clearing them with our mutual fund boards only to be told subsequently that one of the states did not agree that 144(a) securities could be liquid and, as far as they were concerned, they were restricted and therefore illiquid and they didn't want to hear about 144(a) and I think it frustrated a very laudable regulatory effort by the SEC because that limit applied to everybody who sold in Ohio, which was nearly all mutual funds.

Mr. WHITE. The state that objected to this was Ohio?

Mr. HAAGA. I probably shouldn't have said that but, yes.

Mr. WHITE. The home of the Cleveland Indians who beat the Seattle Mariners in the playoffs. That is a problem we have been facing for a long time around here.

Did any of the rest of you have examples that you wanted to make for the record.

Mr. RIEPE. Let me mention, we could use up, I am afraid, your entire day with these stories, if you gave us the opportunity, but a state steps in after—on a fund that was going to invest in foreign government bonds and all the proper disclosures are made in the prospectus working with the SEC staff and then you go to the state

and the state says that that disclosure is inadequate, that in their view foreign government bonds should be treated as junk bonds, high-yield bonds and they require all the disclosure that goes with investing in junk bonds to go on the front of the prospectus of this document. Now, you have a choice of somehow trying to figure out how to sticker—put a sticker with that disclosure in just those prospectuses that go to just that state or what happens, because administratively that is almost impossible, you end up establishing that standard for all states. So now you have a disclosure that says that foreign bonds are junk bonds.

Mr. WHITE. You know, that is interesting. I practiced law for 15 years until just this last January and I was a business lawyer and my office was just down the hall from the securities people in our firm and I do remember very, very clearly the weeks on end of them tearing their hair out as they had to go through 50 state blue sky requirements for just about any sort of offering that they dealt with, so I recognize that some of these can be a problem.

Ms. Smythe, let me ask you one question because you refer to this 100 person limit on the private investment companies, and I would be interested in your thoughts if there really is no limit, is to be no limit and we just had qualified investors involved, could that reach a point where there are 1,000 people or 5,000 people where it really would get out of hand or what is your thinking on that subject?

Ms. SMYTHE. Obviously, if there is no ceiling then it is hard to prescribe what the probable limit would be but my understanding is certainly it is the case with Tiger and I believe it is the case more generally that we are not talking about funds of an enormous size because the limitations, the sophisticated or qualified investor limitation would act as a natural ceiling.

Ranking Minority Member Markey asked me before whether the SEC monitored the size of these funds and the fact is funds like Tiger take—you know take and have to take that 100 investor limit very seriously because if they do breach it and especially a company that is aware of this law does breach it, the consequences are draconian. So, for them, the 100 investor limit really forms sort of like a picture of some kid that has outgrown his—you know, his play pen. I mean, you just can't stand up straight anymore because there is too much of an imposition.

But I would say for funds of the familial or societal nature, if they go over 100 and the SEC finds out about it because somebody had twins, the SEC isn't going to come down on them very hard. But on Tiger they would and should. I mean, companies that knowingly breach that limit really ought not to be allowed to do it.

Mr. MARKEY. Thanks very much and thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The Chair will note that there is a vote pending on the floor, it appears that there will be multiple votes. So that we don't inconvenience the witnesses, I am about to dismiss the panel. But what I would like is written commentary from you specifically on the Federal/state relationship question. My friend from Massachusetts I think correctly has pointed out it is an issue that has a high degree of sensitivity.

We do plan to have a panel of state regulators to come and give us their views and so I would request that you be as specific as possible relative to problems that you have experienced and I would ask a specific question, whether or not Chairman Levitt has laid the predicate for a solution in his statement last week.

Also, Ms. Smythe, regarding the MFA issue you raised, I would also like to get a specific response from you and I apologize that you have not had time to verbalize that this morning.

With that, this hearing is adjourned.

[Whereupon, at 11:43 a.m., the hearing was adjourned.]

[Additional material submitted for the record follows.]

PREPARED STATEMENT OF THE MANAGED FUTURES ASSOCIATION

Mr. Chairman, Members of the Subcommittee: The Managed Futures Association thanks the Chairman and members of the Subcommittee, and appreciates the opportunity to present its written testimony on H.R. 1495, *The Investment Company Act Amendments of 1995,* to express our strong support for the modernization of the private investment company provisions of this Act and to recommend slight modifications to the bill that will significantly aid the growth and further development of the United States ("U.S.") financial services industry. Chairman Fields deserves substantial credit for undertaking the tremendous task of examining anachronisms of this statute, which has remained essentially unchanged for more than half a century, and adapting its provisions to current market realities to ensure that the U.S. financial services industry will continue to provide significant benefits to our economy and remain competitive in the global marketplace.

The Managed Futures Association ("MFA"), the managed futures industry's trade association, has over 500 members who have contributed to the development of this country's futures markets as the world's finest and the global model. MFA's membership, comprised primarily of registered commodity pool operators and commodity trading advisors regulated under the Commodity Exchange Act (the "CEA") by the Commodity Futures Trading Commission (the "CFTC"), provides professional discretionary management to the more than $20 billion invested in managed futures products, including commodity pools or funds and managed accounts. In addition, managed futures trading represents over ten percent of the more than 525 million futures and option on futures contracts traded yearly on U.S. commodity futures exchanges. Commodity funds provide investors with professional management and limited liability while also providing diversification to their traditional portfolio investments and the potential to significantly enhance total portfolio returns. These funds can provide important professionally managed portfolio diversification to small investors who otherwise would have no access to professional management of their assets in these markets. By providing significant liquidity to the futures markets, commodity funds also enable institutions, corporations pension plans, farmers and others to hedge effectively against their respective market risks. In addition, managed futures confers benefits on the U.S. economy by employing countless persons at futures exchanges and brokerage houses and as accountants, lawyers and other services providers.

MFA members and the products they offer are more stringently regulated than any other financial group and product in the world.[1] The CFTC in administering the CEA, oversees and monitors the business activities of commodity pool operators and commodity trading advisors through registration, disclosure, record keeping and reporting requirements and regulates the activities of the commodity brokers through which these funds place their trades as well as the activities of the commodity exchanges on which these transactions are executed. The National Futures Association, the self regulatory body of the industry, also regulates the sales, promotional and operational activities of all these entities. Each of the exchanges on which these contracts trade also regulates the activities of those trading on their markets. In addition, the offer and sale of interests in commodity funds are subject

[1] Edward J. Swan, "The Rise & Decline of Futures Trading in America," *The Futures & Derivatives Law Review,* Issue 1 (1994): 41 notes that with respect to futures regulation, the U.S. has eight major regulatory bodies *(excluding smaller exchanges and state regulators),* whereas the United Kingdom ("U.K.") has four. The U.S. has nearly 12 regulators per 1000 people working in the industry, whereas the U.K. has only five to seven, and the annual cost of regulation to the industry is between $150-$500 more per industry employee in the U.S. than it is in the U.K.

to both the Securities Act of 1933, requiring registration of interests sold publicly and mandating disclosure, and the Securities Exchange Act of 1934, as well as each of the 51 states securities laws. As a result of their structure and the evolution of their products, today these entities and the advisors that trade for them, must also be concerned with inadvertently falling within the definition of an investment company under the Investment Company Act of 1940 (the "Company Act") and investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act").

It was never the intent of Congress in enacting the Company Act or the Advisers Act to regulate the activities of commodity pools or commodity trading advisors. Rather, these statutes were enacted in 1940, almost 35 years prior to the development of the managed futures industry and its regulatory regime, to regulate the activities of investment entities and advisers primarily engaged in making investments in securities in the U.S. capital markets. As a result, unlike banks, insurance companies and certain other entities secondarily invested in securities in connection with their business activities that were statutorily exempted from the Company Act and the Advisers Act, commodity pools and their advisors had no such exemptions. Unfortunately, these statutes have not been amended for more than half a century. Yet much has changed in the markets and in the financial services industry within the U.S. In the interim, the managed futures industry has developed as an integral and substantial business activity in the U.S. economy, providing market liquidity to aid the price discovery function of the futures markets and significant investment opportunities as a fundamental form of diversification from traditional investment products, to both institutions and small investors alike, in an asset uncorrelated to their securities profiles. With the development of these businesses came the need for a rational system of regulating them. In light of the very different purposes of the futures and capital markets and the very different objectives of those who trade or invest in them, respectively, Congress recognized the need for separate and a differing form of regulation of these markets and products.[2] The CEA was comprehensively amended and the CFTC created in 1974 to regulate futures markets and products.

As currently administered, there is significant regulatory overlap for commodity pools regulated under the CEA that inadvertently may fall within the definition of an investment company under the Company Act and for commodity trading advisors regulated under the CEA that fall within the definition of an investment adviser under the Advisers Act. The structure, nature and operation of investment companies and commodity pools are very different due to their very different investment purposes.[3] Neither a commodity pool nor an investment company can operate under the regulatory regime applicable to the other. Similarly, historical differences exist between the businesses of investment advisers and commodity trading advisors. While certain of these differences might be reconciled without significant disruption in the underlying business, other differences reflect significant dissimilarity in the nature or development of the services provided. Application of the Company Act or Advisers Act regulatory regimes to commodity businesses may substantially impair or eliminate such business. The effect of the current state of the law has been to inhibit the business, and stifle the creation and trading diversification, of commodity pools and to unnecessarily restrict trading by commodity trading advisers as a result of the lack of sufficient objective exemptions from the provisions of the Company Act and the Advisers Act with no corresponding customer protection or market integrity purpose.

Managed commodities trading represents a fundamental form of diversification from traditional equity investments. The nature and objectives of these two activities and the differences between risk transfer and capital formation markets has historically, and continues, to justify differing regulatory approaches. Inevitably there may be some overlap at the margins among any differing regulatory approaches. Nonetheless, the existing regulatory framework in the U.S. can most easily be rationalized by utilizing fully the concept of a prime regulator and exempting primary activities falling under other regulatory regimes. Regulation should be coordinated where it makes sense to do so, while giving appropriate recognition to the characteristics of the differing investment vehicles or instruments traded.

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[2] By employing professional management through individual accounts or commodity pool investments, managed futures investors seek to profit from trading instruments that capitalize on fluctuations in market price levels, as opposed to investing capital in operating companies. Managed futures professionals obtain profit potential and diversification from trading the risk transfer markets and rely on price movements in an active auction market as opposed to investing in the capital markets.

[3] For example, the Company Act and the rules and regulation thereunder are geared, in general, to entities in corporate form, as most investment companies are structured as corporations. Commodity pools, however, are generally formed as limited partnerships.

REGULATION BY PRIMARY ENGAGEMENT.

While the Securities and Exchange Commission (the "SEC") has recognized the concept that commodity pools are engaged in a primary business other than securities trading, the measurement of the primary business of commodity pools is inconsistent with market realities and has had a chilling effect on the activities of these entities. U.S. financial regulation has not, in this context, kept pace with economic reality. It has become a matter of urgency to provide some certainty in the marketplace concerning which funds are commodity pools and which investment companies. While the SEC conception of primary engagement measured by subjective factors perhaps was marginally sufficient for early plain-vanilla commodity funds,[4] the managed futures business has become more sophisticated and more competitive and the needs of the investors for more efficient investment vehicles have resulted in structural changes to the model.[5] Perhaps more than any other single factor, the unsettled and subjective state of the law is driving U.S. investment talent offshore. Many of the most skilled and successful U.S. money managers refuse to jeopardize their businesses by the uncertainty of regulatory sanction when, having made reasonable, good faith efforts to make an appropriate determination under these subjective tests, they nonetheless may be subject to challenge by a regulator. As a result, the development of innovative financial products available for U.S. investors has been stifled significantly. The U.S. has increasingly lost significant trading talent to offshore investment, which deprives domestic investors not only of return potential, but also limits portfolio diversification in instruments traded and access to certain trading strategies as a result of restrictions or legal ambiguity in the trading of certain instruments.[6] A futures money manager can implement the same strate-

[4] A commodity pool typically maintains the vast majority of its assets in cash or government securities which are available to margin its futures contract obligations. Any entity comes within the definition of an investment company under § 3(a)(1) of the Company Act if it is, or holds itself out, as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. Alternatively, the entity's failure of the objective test of § 3(a)(3) of the Company Act creates a presumption of investment company status that can be rebutted upon showing that the company is exempt under § 3(b)(1) by being "primarily engaged" in some business other than securities investment. While there are substantive differences between the two tests in § 3(a)(1) and § 3(a)(3) of the Company Act, the evaluation of being "engaged primarily" or "primarily engaged" under § 3(a)(1) and § 3(a)(3) is the same. Five subjective factors have been identified in several no-action letters by the SEC to determine an entity's primary engagement, the most important of which is the present source of its income and the composition of its assets. For commodity pools, the income test is especially onerous. Unfortunately, due to the sometimes volatile nature of futures returns, it is possible that the futures returns will be flat or even negative, yet the pool will receive interest income from the maintenance of initial margin posted for its commodity positions as well as having a substantial portion of its remaining funds not actively being needed to margin its commodity positions in interest bearing obligations. Thus, a pool either must forego investment of its excess funds in interest bearing obligations (to the detriment of its investors) or constantly review its source of income and be concerned that it might be deemed to be an investment company and become subjected to a different and sometimes contradictory regulatory regime. This situation is exacerbated by the second most important indicator, the composition of its assets, in circumstances in which the pool has invested in a trader entity which will be included in the calculations as an investment security, and thus may cause the pool to also fail this factor of the test. See discussion in footnote 5.

[5] The vagaries of the futures markets as a result of their auction style marketplace, frequently result in differing prices or partial executions of large orders. If an advisor manages commodity pools, each as a managed account, he must devise a methodology for fairly allocating the partial number of contracts that were executed and the multiple prices among each of his accounts. Some of these accounts invariably will receive fewer contracts or at a worse price then others. Because of the administrative inefficiencies and increased costs, including the administrative cost and difficultly (which frequently results in increased fees to clients) in reconciling the multiple transactions to numerous accounts traded by an advisor and of attempting to have fair and equitable treatment across their various client accounts, many advisers have formed investment entities, generally limited partnerships, in which all their accounts must invest in order to obtain their advisory services. The profits and losses of the one partnership account, rather than separate futures contracts are allocated among investors. Therefore, in order for a commodity pool to have these advisors trade for their pool, the pool must invest in the advisor entities. Under the Company Act, this investment then falls within the definition of investment security. In addition, the pool operator, by structuring its pool to invest in these advisor entities, is providing investment advice with respect to securities within the meaning of the Adviser Act. However, the whole point of the pool's investment is to access an advisor to professionally manage investor assets in the futures markets.

[6] Industry statistics are unable to measure the "chilling" effect of these statutes as they do not capture those who have restricted their business operations in an effort to be outside the reach of these statutes nor reflect the detriment to investors as a result of these restricted busi-

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gies in far more markets offshore than domestically. The objection is not to regulation per se, but to duplicative uncertain and irrational regulation.

U.S. markets are burdened with serious competitive disadvantages by its complex system of futures and securities regulation which increases transaction costs and stifles the ability to respond to changing market conditions. The system must be streamlined. Section 3(a)(3) of the Company Act currently embodies an objective test of when an entity should be deemed to constitute an investment company. However, the statute needs to make clear what it already implies—namely, that if 60% of an entity's assets are commodity interest contracts, that entity will be deemed a commodity pool. We urge that the means by which the 40%/60% is computed be clarified by specifying the full contract value of commodity interests be utilized for purposes of the computation. As noted above, virtually all of the commodity pool's assets are maintained in cash and interest bearing obligations to support its futures transactions to be utilized as margin in times of extreme volatility of the instruments it trades. While a commodity pool may engage in a de minimis amount of what is defined as "securities" trading or invest its excess cash to obtain a return slightly higher than the T-Bill rate or may invest a portion of its assets in another commodity pool to obtain access to otherwise unavailable trading advisors, there is never an issue as to the economic primary purpose of the entity. Under the current objective test in the Company Act, U.S. government securities and cash are excluded from total assets (the denominator) in applying the formula to determine whether or not an entity falls within its definition of an investment company. Thus, the denominator shrinks, and any securities investment becomes an artificially high percentage of total assets. In addition, commodity pools with any investment in an advisor's entity will automatically fail. As a result, it is impossible for commodity pools to meet the objective test. This unwarranted result can be reversed by valuing commodity interest contracts at the face value of the underlying commodity for purposes of the objective test. It is insufficient to compare simply the amount being actively utilized in margin at any point in time to assess the pool's commitment to commodity trading, as that amount, which is merely a good faith deposit and not a portion of the purchase price, generally ranges from only 5-30% of the purchase price. In addition, as a result of the sometimes significant daily variations that can occur in margin requirements, it is unsatisfactory for use as a determinant of the manner in which an investment entity should be regulated.

Similarly, there is no exemption from the investment adviser definition for commodity trading advisors who are primarily engaged in the provision of commodities advice, including advice regarding investment by one commodity pool into another commodity pool that is primarily engaged in commodities trading. Currently, the giving of any "securities" advice may cause a CTA or CPO to come within the definition of an investment adviser.

SIGNIFICANT REPERCUSSIONS OF COMPANY ACT AND ADVISOR ACT STATUS.

The consequences of a commodity pool's or commodity advisor's incorrect determination of its status under these statutes is draconian. A commodity pool deemed to be an investment company, even if inadvertently, would be required to register under the Company Act. As a registered investment company, the pool could not sell its securities or those of other entities by use of the mails or any other means of interstate commerce and could not engage in any business in interstate commerce. A commodity pool would, in effect, have to register or dissolve. However, due to the significant limitations on its structure and operations, a commodity pool would have no choice but to dissolve.[7]

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ness activities. However, these statistics indicate the response of those who are able to move their operations offshore or to offer their products solely to non-U.S. investors, and the trend is alarming. In 1989, the first year in which statistics are available for offshore funds, industry statistics prepared by *Managed Account Reports, Inc.* reported 109 U.S. public futures funds, 61 U.S. private funds and only 20 offshore funds. In 1993, the number of U.S. public futures funds had increased by 78%, U.S. private funds by 286% and non-U.S. futures funds by 410%. The statistics collected through September of 1995 show the absolute number of non-U.S. futures funds now exceeds both the number of U.S. public futures funds as well as U.S. private funds by almost 29% and 3%, respectively, and the number of U.S. public futures funds and U.S. private funds has *declined* by over 37% and 23%, respectively, since 1993 while the number of non-U.S. futures funds has *increased* by 54% in the same period.

[7] Two of the most significant limitations of the Company Act are the custody provision, that might preclude the opening of commodity accounts, and the treatment of futures contracts as "senior securities" under § 17(f). For a commodity trading advisor, the Advisers Act prohibits incentive fee compensation which is the primary basis of his/her compensation. Accordingly, investors might have rescission rights or an ability to obtain a refund of fees paid, even with respect to compensation paid solely as result of futures trading activities.

These statutes need to be amended in the manner reflected in Appendix A hereto to provide an exemption from regulation for investment entities primarily engaged in commodities trading (measured to give full value to commodity trading activities), including when a portion of its assets are invested in other commodity pools, and for an advisor primarily engaged in giving commodities trading advice. No customer protection or other regulatory purpose is served by the continuing ambiguity, legal uncertainty and potential regulatory overlap caused by the existing statutes. Commodity pools and the advisors who trade in the commodity markets on their behalf, not unlike other businesses that secondarily invest in securities in connection with their primary business activities, should have a clear, objective exemption from these statutes. The CFTC is, and should be, the prime regulator of these entities and persons and has more than sufficient regulations and legal authority to oversee and prescribe their activities. For that matter, an exemption should also be made in both statutes from substantive regulation by each of the fifty states, similar to that contemplated in H.R. 2131, also introduced by Chairman Fields. It makes no sense for substantive regulation of investment companies and investment advisers to vary state by state. No investor protection or market integrity benefit is gained by the duplication of regulation, yet U.S. competitiveness and innovation are threatened by the burden, cost and chilling effect of this overlapping regulation.

PRIVATE OFFERING AND QUALIFIED PURCHASER EXEMPTIONS

Because of the expansive definition of "investment company" under the Company Act and "investment adviser" under the Advisers Act and the high degree of regulation imposed under these statutes, the statutes contain a number of statutory exceptions and exemptions, and grant broad exemptive authority to the SEC. These provisions, including the exception for private investment companies, recognize that federal regulatory protection of transactions among certain participants is both unnecessary and impractical. The intent of § 3(c)(1) of the Company Act is to except from the definition of an investment company (and thus from all provisions of the Act) private companies in which there is not significant public interest and which are, therefore, not appropriate subjects of federal regulation. Because this exception also is limited by the requirement that the company is not, and does not presently propose to make a public offering, arguably that requirement in and of itself would suffice to ensure that this exception is not utilized by companies in which there is significant public interest. The additional requirement that fewer than 100 investors have an economic interest in the company contains an arbitrary numerical limitation that attempted to gauge the appropriate degree of public interest that would warrant federal protection. In light of the requirement that the issuer not make a public offering and the fact that investment participation and sophistication, not to mention the population of the U.S., has increased more than ten fold since the enactment of the Company Act, it is appropriate that the arbitrary number be increased by an appropriate percentage.

The proposed amendments also would add a new § 3(c)(7) to the Company Act to exempt offerings to highly sophisticated investors on the theory that such investors are capable of safeguarding their own interests and are not in need of federal regulatory protection. Non-U.S. and, to a lesser extent, certain U.S. regulators, generally recognize a two tier regulatory approach in enacting statutes which distinguish transactions with the general public from those among professional, sophisticated or creditworthy participants. Appropriate exemptions for qualified participants permit federal resources to be better focused and utilized for those in need of such protection. However, a qualified purchaser exception should exempt participants based on realistic qualification requirements, which will pertain to more than a de minimis percentage of the population. Finally, as it is impossible to define by statute all circumstances in which an investor is the equivalent of a qualified purchaser even though he does not meet the precise statutory qualifications, the SEC, as the expert agency that historically has been granted broad discretion in the administration of exemptions under these statutes, should be granted discretion to determine other investors as qualified, consistent with the parameters of the exemption.

Purely as a matter of implementation, MFA's proposed amendment seeks to avoid disrupting existing investor relationships in enacting these new exemptions. In light of the significant benefits, most notably that of legal certainty, that would accrue to issuers utilizing the § 3(c)(7) exemption, an amendment needs to be added to avoid the ousting of existing investors that would not qualify under the qualified purchaser definition. Since such investors have existing investments in the issuer that, prior to the enactment of the § 3(c)(7) amendment, have not been subject to Company Act regulation, the investments of these investors should be grandfathered. In light of the significant and unnecessary cost of creating new funds,

(with no commensurate investor protection benefit), which cost is ultimately passed on to investors, there is no justification for requiring existing funds to create new structures or new funds to be able to utilize the new exemptions.

Last, absent a provision that specifies that offerings pursuant to § 3(c)(7) will not be integrated with § 3(c)(1) offerings, existing § 3(c)(1) issuers would be unable to take advantage of the new exemption with similarly structured funds. In light of the qualification requirements of § 3(c)(7), it is difficult to argue the nonintegration amendment will raise customer protection issues, but its adoption would most efficiently facilitate issuers' use of the new exemption.

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